UTMOST GOOD FAITH IN THE REINSURANCE RELATIONSHIP[1]

By

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I. Introduction

Perhaps the most fundamental custom and practice of the reinsurance business is utmost good faith.[2] This principle has been characterized as the "bedrock"[3] and "cornerstone"[4] of reinsurance. Nonetheless, a practical definition of utmost good faith that can be applied to real facts remains elusive.

The purpose of this article is to examine the definitions of utmost good faith articulated by certain commentators, examine case law on the principle and its application to the facts of those cases and to suggest a practical definition of the custom and practice of utmost good faith.[5]

II. Definitions of Utmost Good Faith by Various Commentators

A leading text on reinsurance defines utmost good faith as:

> A defining characterization or quality of some (contractual) relationships of which reinsurance is universally recognized to be one. Among other differences from ordinary relationship, the nature of reinsurance transactions is dependent upon a mutual trust and lively regard for the interests of the other party even if inimical to one's own. . . .[6]

Black's Law Dictionary defines "uberriamae fides" (the Latin version of utmost good faith) as:

> The most abundant good faith; absolute and perfect candor or openness and honesty; the absence of concealment or deception, however slight. A phrase used to express the perfect good faith concealing nothing, with which a contract must be made; . . . .[7]

One former reinsurance company CEO characterized utmost good faith as follows:

> [U]tmost good faith in reinsurance is not a duty of only one party toward the other, but a mutual duty each party owes the other. The duty exists with respect to any action necessary or desirable in order to place and maintain both parties within a fair and equitable bargain. Neither party may mislead or baulk the other

> in the legitimate realization of these goals, notwithstanding the goals are mutually exclusive.[8]

There are several problems with these sorts of definitions. First, they suggest that utmost good faith rises to the level of a fiduciary duty, which case law generally has not so found.[9] Even ratcheted down a bit, these definitions provide scant practical guidance as to a rule that can be applied readily to actual disputes.

III. Case Law Applying Utmost Good Faith

A. Seminal Case

The seminal case on point is *Sun Mutual Ins. Co. v. Ocean Ins. Co.,* 107 U.S. 485 (1883). The cedent initially provided ocean marine insurance to a freighter with a charter from New York to San Francisco. However, the master of the vessel obtained a second charter from San Francisco to Peru and various islands. The cedent provided additional limits as a result of the second charter and purchased reinsurance on the full limits but without revealing the second charter to the reinsurer. When the vessel was lost during the first charter, the reinsurer declined to indemnify the cedent.

The Supreme Court found for the reinsurer stating: "In respect to the duty of disclosing all material facts, the case of reinsurance does not differ from that of an original insurance. The obligation in both cases is one of unberrimoe (*sic)* fidei."[10] The court went on to adopt a rule advocated by an industry commentator and to apply it in the reinsurance context:

> It is the duty of the assured to place the underwriter in the same situation as himself; to give to him the same means and opportunity of judging of the value of the risks; and when any circumstance is withheld, however slight and immaterial it may have seemed to himself, that, if disclosed, would probably have influenced the terms of the insurance, the concealment vitiates the policy.[11]

B. Reinsurance Placement

Christiania General Ins. Corp. v. Great Am. Ins. Co., 979 F.2d 269 (2nd Cir. 1992) involved a misrepresentation/omission defense by the reinsurer for the failure of the cedent to highlight in reinsurance placement materials the dangerous propensities of all terrain vehicles ("ATVs") manufactured by the insured, Honda. Quoting *Sun Mutual*, *supra*, the court stated:

> The reinsured's duty of good faith, in the absence of specific inquiry, requires it "to place the underwriter in the same position as himself [and] to give to him the same means and opportunities of judging the value of the risks." If [the cedent] reasonably had no reason to believe [the reinsurer] would consider Honda's distribution of ATVs material to the nature of the risk because it did not itself so regard this fact at the time, and [the reinsurer] did not inquire, it cannot be said

> that the failure to disclose such information deprived [the reinsurer] of the same opportunity [the cedent] had to assess the risk.[12]

The *Christiania* court ruled that the cedent did not have sufficient knowledge of the dangerous propensities of ATVs at the time of the placement to highlight them.

Compagnie de Reassurance D'Ile de France v New England Reins. Corp., 57 F.3d 56 (1st Cir. 1995) was an action for rescission by retrocessionaires based on various defenses including fraud in the inducement during placement. The court commented:

> The plaintiffs argue, and the district court found, that the defendants were under a duty to the plaintiffs of utmost good faith ("*uberrimae fidei"*). The defendants refer to the same standard. We agree that a **reinsurer** like NERCO, having obtained by treaty the power to impose significant **risks** and liabilities upon plaintiff retrocessionaires, owed to them the utmost good faith in its dealings under the treaties (citing *Unigard, infra*).
>
> This means that, as the district court properly recognized, defendants owed plaintiffs a duty "to exercise good faith and to disclose all material facts." In the non-marine context, however, a claim of fraud may not be found on *innocent* misrepresentations and concealment. (Emphasis in the original)[13]

The court went on to reverse the lower court based on insufficient evidence of the various elements of fraud.

A loss under a marine insurance policy was involved in *Reliance Ins Co. v. Certain Member Cos.*, 886 F. Supp. 1147 (S.D.N.Y. 1995). The reinsurers were led to believe that the cedents had a substantial retention when, in fact, 100% of the risk was ceded to the reinsurers. The reinsurers sought to rescind the reinsurance contract. On the issue of utmost good faith, the court stated:

> The doctrine of uberrimae fidei developed out of the recognition that the marine insurance contract "is conceived in the utmost good faith and incubated in a legal environment which transcends the sharper practices of the world of commerce."
> . . . .
> "[T]he parties to a marine insurance policy must accord each other the highest degree of good faith . . . . This stringent doctrine requires the assured to disclose to the insurer all known circumstances that materially affect the risk being insured."
> . . . .
> A contract will not be voided under the doctrine of *uberrimae fidei* "unless the undisclosed facts were material and relied upon."
> . . . .
> The courts have recognized that the doctrine of *uberrimae fidei* is particularly

> important in the reinsurance context because of the "special relationship that exists between reinsured and reinsurer." (Citations omitted.) [14]

The *Reliance* court ruled for the reinsurers holding that the cedents' obligation of utmost good faith required that they reveal that the cession was for 100% of the risk.[15]

In the Matter of the Liquidation of Union Indemnity v American Centennial of N.Y., 674 N.E.2d 313 (N.Y. 1996) involved a claim for rescission by reinsurers due to failure by the cedent to reveal its insolvency at the time of placement. The fact of insolvency had been revealed in court documents filed in other proceedings. On the issue of utmost good faith, the court stated:

> The phrase *uberrimae fidei* and its translation, "of the utmost good faith," has long been used to characterize the core duty accompanying reinsurance contracts. Encompassed within this duty is a basic obligation of a reinsured to disclose to potential reinsurers all "material facts" regarding the original risk of loss, and failure to do so renders a reinsurance agreement voidable or rescindable. Material facts are those likely to influence the decisions of underwriters; facts which, had they been revealed by the reinsured, would have either prevented a reinsurer from issuing a policy or prompted a reinsurer to issue it at a higher premium.[16]

The court allowed rescission on the basis that insolvency at the time of reinsurance placement was a material omission.

C. Reinsurer's Obligation

Commercial Union Ins. Co. v. Seven Provinces Ins. Co., 217 F.3d 33 (1st Cir. 2000) *cert. denied* 531 U.S. 1146 (2001) is about a reinsurer going to extraordinary lengths to avoid paying a loss. The court found that the reinsurer pursued a deliberate avoidance strategy through constantly shifting defenses and objections that were designed to pressure the cedent into a settlement. The court concluded that this strategy constituted bad faith. As to utmost good faith, the court stated:

> "Utmost good faith . . . requires a reinsurer to indemnify its cedent for losses that are even arguably within the scope of the coverage reinsured, and not to refuse to pay merely because there may be another reasonable interpretation of the parties' obligations under which the reinsurer could avoid payment." . . . . Viewed in light of the exacting standard of uberrimae fides, (the reinsurer's) bad faith tactics were wholly alien to the usual course of dealings between an insurer and a reinsurer, and thus were even more clearly removed from an ordinary breach of contract. (Citation omitted.)[17]

D. Claim Reporting

Unigard Security Ins. Co. Inc. v. North River Ins. Co., 4 F.3d 1049 (2nd Cir. 1993) is a case in which a facultative reinsurer asserted a defense of late notice on asbestos-related losses. The cedent had joined the Wellington Facility which 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 it facultative reinsurers.

In the course of its opinion, the *Unigard* court discussed the historical background and financial underpinnings of utmost good faith:

> [R]einsurers are dependent on their ceding insurers for prompt and full disclosure of information concerning pertinent risks. 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. Reinsurance works only if the sum of reinsurance premiums are less than the original insurance premium. Otherwise, the ceding insurers will not reinsure. For the reinsurance premiums to be less, reinsurers cannot duplicate the costly but necessary efforts of the primary insurer in evaluating risks and handling claims. Reinsurers may thus not have actuarial expertise or actively participate in defending ordinary claims. They are protected, however, by a large area of common interest with ceding insurers and by the tradition of utmost good faith, particularly in the sharing of information. (Citation omitted.)[18]

Turning to the reinsurer's defense of bad faith in failing to report claim information, the *Unigard* court initially quoted *Sun Mutual, supra,* and *Christiania, supra*:

> [T]he duty of good faith requires the ceding insurer to place the reinsurer "in the same [situation] as himself [and] to give him the same means and opportunity of judging . . . the value of the risks." . . . . [B]ecause information concerning the underlying risk lies virtually in the exclusive possession of the ceding insurer, a very high level of good faith – whether or not designated as "utmost" – is required to ensure prompt and full disclosure of material information without causing reinsurers to engage in duplicative monitoring.
> . . . .
> We . . . think that the proper minimum standard for bad faith should be gross negligence or recklessness. If a ceding insurer deliberately deceives a reinsurer, that deception is of course bad faith. However, if a ceding insurer has implemented routine practices and controls to ensure 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 loss notice defense should succeed. [19]

Based on this standard, the court found that the cedent did not act in bad faith with respect to claim reporting.[20]

The Supreme Court of New Hampshire followed *Christiania, supra* and *Unigard, supra* in *Certain Underwriters at Lloyd's London v. Home Ins. Co.*, 783 A.2d 238 (N.H. 2001). The claim at issue 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 claim 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 total lack of a system to report claims to reinsurers:

> 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.[21]

Granite State Ins. Co. v. Clearwater Ins. Co., 2014 U.S. Dist. Lexis 44573 involved a large number of asbestos-related claims against the insureds of Granite State and other affiliated AIG companies. After many years of litigating and negotiating, AIG settled its claims on a group basis, allocated losses to two Granite State policies with facultative reinsurance and then gave notice to the reinsurers. The court's opinion analyzed the late notice issue under both Illinois law, which does not require prejudice from late notice, and New York law that does require prejudice. The court found a breach of the notice provision under New York law based on the duty of utmost good faith:

> [E]ntering into those settlements without any notice to Clearwater was a knowing disregard of millions of dollars in risk to Clearwater. Accordingly, the court finds that no reasonable jury could conclude that Granite State met its duty of utmost good faith. Thus, plaintiff breached its duty of utmost good faith to Clearwater as a matter of law. That breach, when coupled with the untimely notice provided, bars Granite State's claim for coverage under New York Law.[22]

See also, Ins. Co. of the State of PA. v. Argonaut Ins. Co., 2013 U.S. Dist. Lexis (S.D.N.Y) in which the court predicted that California state courts would adopt a similar rule with respect to failure of a cedent to adopt adequate practices and controls necessary to give notice of losses to reinsurers.

E. Coverage Issues

Property coverage for a French warehouse was at issue in *Allendale Mutual Ins. Co. v. Excess Ins. Co.,* 992 F. Supp. 278 (S.D.N.Y. 1998). The reinsurance binder contained a handwritten note to the effect that reinsurance coverage was subject to compliance within 60 days with the recommendations of a survey of the warehouse commissioned by the cedent. The survey contained a number of recommendations with which neither the insured nor the cedent attempted to comply. The court stated:

> Under New York law, a reassured owes to its reinsurer a duty of "uberrimae fidei," a phrase generally translated as "the utmost good faith." The core of this duty "is a basic obligation of a reinsured to disclose to potential reinsurers all "material facts" regarding the original risk of loss, and failure to do so renders a reinsurance agreement voidable or rescindable. . . . This doctrine imposes no duty of inquiry upon a reinsurer; rather, the burden is on the reassured to volunteer all material facts. . . . (Citations omitted.)
>
> . . . .
>
> A fact is "material" for purposes of the uberrimae fidei doctrine if it "would have either prevented a reinsurer from issuing a policy or prompted a reinsurer to issue it at a higher premium" had it been disclosed before the contract was executed.[23]

The court found that failure to comply with the survey results was a material omission and granted rescission.

A cession of a business interruption risk was at issue in *United Fire & Cas. Co. v. Arkwright Mutual Ins. Co.*, 53 F. Supp. 2d 632 (S.D.N.Y. 1999). The cedent did not request reinsurance coverage for or give notice of an endorsement for an extended period of liability ("EPL") that became relevant after the Northridge earthquake. On the issue of utmost good faith, the court stated:

> A reinsured owes its reinsurer a duty of utmost good faith. The doctrine of utmost good faith imposes no duty of inquiry upon a reinsurer. Rather the burden is on the reinsured to volunteer all material facts.
>
> . . . .
>
> Utmost good faith also requires a reinsurer to indemnify its cedent for losses that are even arguably within the scope of the coverage reinsured, and not to refuse to pay merely because there may be another reasonably interpretation of the parties' obligations under which the reinsurer could avoid payment. (Citations omitted.)[24]

The court found there was no reinsurance coverage for the EPL endorsement since the cedent had never requested coverage for the EPL endorsement and the reinsurer had not agreed to provide it.

IV. A Practical Definition of Utmost Good Faith

In terms of a general, but practical, standard for the custom and practice of utmost good faith, the case law cited above suggests that a cedent and reinsurer must hold the interests of the other as dearly as its own interests. Thus, one party cannot, without cause, take actions to elevate its interest above those of the other.

In the reinsurance placement context, the case law cited above suggests that the custom and practice of utmost good faith requires that the cedent reveal to the reinsurer those facts that the cedent knows or should know would be material to the reinsurer's evaluation of the risk. "Material" in this context means those facts which cause the reinsurer to decline the risk or which would produce a significant difference in underwriting risk factors.[25]

In the claims context, case law cited above suggests that the custom and practice of utmost good faith requires that a reinsurer cannot be completely unresponsive, repeatedly ask the same questions or for material that does not exist or pose defenses or objections in serial fashion in order to elongate the process and/or induce a settlement.

In a claim-reporting context, case law cited above suggests that the custom and practice of utmost good faith requires that a cedent not be grossly negligent or reckless with respect to its contractual obligations to report claims. In addition, a cedent is required to have systems and procedures reasonably designed to fulfill its contractual obligations with respect to reporting claims.

In a coverage context, case law cited above suggests that the custom and practice of utmost good faith defines the reinsurer's coverage as that reasonably within the risk submitted by the cedent and agreed to by both parties.

ENDNOTES

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[1] The author acknowledges and thanks Teresa Snider, Esq. of Butler Rubin for her compilation of case law, articles and treatises on point that was distributed at the 17th Annual Insurance Insolvency and Reinsurance Conference in March of 2010.

[2] Klaus Gerathewohl, *Reinsurance Principles and Practice,* Verlag Verischerungswizrthschaff e.V Karlsruhe (1980) at 460.
[3] Eugene Wollan, *Handbook of Reinsurance Law,* Aspen Publishers (2003) at 3.02 (hereinafter "Wollan").
[4] Robert F. Salm, "Reinsurance Contract Wording", *Reinsurance,* The College of Insurance (1980) at 99.
[5] Given that most reinsurance disputes are resolved through arbitration, case law is not the best tool by which to derive the nature and scope of the custom and practice of utmost good faith. Nonetheless, it is one of the better tools available to working lawyers.
[6] Robert Strain, Editor, *Reinsurance,* The College of Insurance (1980) (hereinafter "Strain") at 79.
[7] Henry Black, *Black's Law Dictionary, Fourth Edition,* West Publishing Co. (1968) at 1690.
[8] Strain at 9.
[9] Robert M. Hall, *Fiduciary Duty in the Reinsurance Relationship,* XVIII Mealeys' Reins. Rpt. No. 9 (2007) at 19. *See also* Wollan at 3.02. For an examination of an outlier case that characterized the principle of utmost good faith as a fiduciary duty and then found that it does not supersede contractual provisions, *see* Robert M. Hall, *Is the Obligation of Utmost Good Faith Dead in Illinois,* XVI Mealey's Reins. Rpt. No. 3 (2005) at 21.
[10] 107 U.S. 485 at 510.
[11] *Id.* at 510-1.
[12] 979 F.2d 268 at 280.
[13] 57 F.3d 56 at 72-73.
[14] 886 F. Supp. 1147 at 1153
[15] *Id.* at 1154.
[16] 674 N.E.2d 313 at 319-20.
[17] 217 F.3d 33 at 43-4.
[18] 4 F.3d 1049 at 1054.
[19] *Id.* at 1069.
[20] *Id.* at 1069-70.
[21] 783 A.2d 238 at 242.
[22] 2014 U.S. Dist. Lexis 44573 *66.
[23] 992 F.Supp 278 at 282.
[24] 53 F. Supp. 632 at 641-2.
[25] While certain cases couch the latter option as an increase in premium, this is a poor articulation of the concept in a reinsurance context. The premium in a quota share context will not change even if there are significant variations in the nature of the risk assumed. Even in an excess of loss context, premium is merely a proxy for variation in underwriting risk to be assumed.