Duties of the Cedent:New Appleman on Insurance Law

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It might be said that while a reinsurer has only one duty, to pay covered claims, a cedent's duties are manifold. The cedent, usually without the consent or participation of the reinsurer, underwrites the risk, administers the business, determines the coverage, pays the claims, and allocates the losses. The reinsurer is bound by these decisions, shares in the cedent's risk, and must pay claims that "even arguably" fall within the scope of coverage. This asymmetrical relationship is balanced by the cedent's duty of utmost good faith in all of its dealings under the reinsurance agreement. Chapter 73 examines the jurisprudence with respect to the manifold duties a cedent owes its reinsurer.

Courts generally acknowledge that a cedent owes its reinsurer a duty of utmost good faith, "a perfect candor" and "absence of concealment" regarding the risk undertaken. Uniformly defining the scope and application of that duty, however, has proven more difficult. This is due, in part, to the fact that reinsurance disputes are often privately arbitrated leaving, until recently, a dearth of reported cases. The wave of asbestos and other environmental mass tort liabilities of the 1980s and 1990s saddled reinsurers with unprecedented losses, usually on agreements decades old. Reinsurers challenged many of these losses and questioned the cedent's good faith in resolving them. As a result, courts found themselves grappling with the traditional rights and duties of cedents and reinsurers, sometimes memorialized only by a slip or binder providing little more than the reinsurer's share of the risk of loss.

In confronting these issues, courts were not without precedent regarding the legal doctrines that govern the reinsurance relationship. In 1837, a New York court first applied what had long been the custom and practice of the industry when it held that a cedent must disclose "every fact and circumstance" that can possibly influence "the mind of any prudent and intelligent insurer," and that failure to do so would void the reinsurance whether "the omission was the result of mistake or design." In 1996, the New York Court of Appeals, citing the 1837 decision, wrote that the duty of utmost good faith obligates a cedent to disclose to its reinsurer "all material facts regarding the original risk of loss, and failure to do so renders the reinsurance agreement voidable or rescindable." While the doctrines of reinsurance jurisprudence, including utmost good faith, follow the settlements, and follow the fortunes, could be clearly articulated, applying these doctrines to mass tort liabilities under the usual strictures of commercial contract law initially produced inconsistent results. These decisions, and their progeny, are now creating trends and establishing default rules widely accepted by courts that regularly handle reinsurance disputes and confirm or vacate reinsurance arbitration awards.

Courts almost universally agree that utmost good faith is a core duty of all reinsurance agreements. And rescission of the reinsurance agreement for the non-disclosure of such information remains the operative legal remedy. As the cedent has superior knowledge of the risks, the duty of utmost good faith requires that it place the reinsurer in the same position as itself, giving the reinsurer the "same means and opportunity of judging the value of the risks." The cedent fulfills this duty by disclosing all facts that "materially affect the risk of which it is aware and of which the reinsurer itself has no reason to be aware." The cedent's failure to disclose material information need not be fraudulent or even intentional, but the party with the duty to disclose must have reason to believe the fact not disclosed is material. If the cedent fails to disclose every fact and circumstance that could possibly influence the mind of a prudent reinsurer, rescission is the appropriate remedy, whether the omission was the result of "mistake or design." A minority of courts have found that the cedent-reinsurer relationship, under a treaty as opposed to a facultative certificate, may give rise to a fiduciary duty. Under a treaty, the reinsurer is automatically bound by risks written by the cedent. As a result, the reinsurer must place complete trust in the cedent's ability, experience, and general integrity. While the cedent's duty under such circumstances is often described as one of utmost good faith rather than a fiduciary duty, more than one court has found it hard to see any principled distinction between these two standards for the purposes of non-disclosure. The majority of jurisdictions, however, have explicitly rejected characterizing the cedent-reinsurer relationship as one that is fiduciary. Courts often note the sophistication of the parties under a reinsurance agreement as eliminating the typical "vulnerability" of one owed a fiduciary duty. Moreover, imposing a fiduciary duty would introduce unrelated and general principles trust and a standard of care to the examination of the cedent's duties in a highly complex and well developed industry specific relationship.

The timely notice of claims is a primary duty of every cedent. Timeliness is the observance of the proper interval between the receipt of information regarding a claim and notice of that claim to the reinsurer, consistent with the terms of the parties' agreement. Reinsurance agreements often require

"prompt notice," notice "as soon as practicable," or "within a reasonable time" after the duty arises. These notice requirements mimic language used in direct insurance policies, and reinsurers frequently draw parallels between a cedent's and an insured's duty of prompt notice, especially in states where direct policy prompt notice requirements are strictly enforced. However, timely notice permits direct insurers to investigate, defend, and pay claims; by contrast, a cedent's duty to timely notice is designed primarily to enable reinsurers to establish reserves, associate in the defense of the claim, and set premium based on actual loss. Moreover, the reinsurer's interests are protected and insulated by a professional insurer managing the claim. In light of these differences, courts have determined that prompt notice is of "substantially less significance to a reinsurer than for a primary insurer." A cedent's duty to timely notice claims depends, in part, upon the specific requirements of an agreement's notice provision. Often prompt notice may require no more than notice when a claim is "likely to involve the reinsurance." Such notice requirements have occasionally been deemed ambiguous as a matter of law, leaving the cedent unfettered discretion to determine when, if ever, a claim might involve the reinsurance. Reinsurers have attempted to limit this discretion by requiring notice regardless of the cedent's assessment of liability or policy limits. Under such provisions, notice may be triggered by a specific occurrence, such as head trauma, hospitalization, or spinal cord injury; it may also be triggered by losses or reserves reaching 50 percent of the cedent's retention. Even these specific triggers, however, have not eliminated the uncertainty of measuring timely notice.

In the absence of a specific trigger, reinsurance agreements typically require notice when a claim is "likely to involve the reinsurance" or "results in or appears" to be of a nature as to "result in a loss involving the reinsurance." While most courts acknowledge that there is more than one plausible meaning of these latter phrases, many have found that even under such "subjective" language a cedent's discretion is not unfettered. A provision requiring notice when it appears likely that a claim will involve the reinsurance "does not require a probability, much less a certainty, that the reinsurance will be involved." What is required is a "reasonable possibility of such happening based on an objective assessment of the information available." A theoretical possibility that the reinsurance will not be involved is not an "objectively reasonable basis" for failing to notice a reinsurer of a claim.

A cedent's duty to notice, however, does not arise from mere speculation or rumor regarding a claim. A reinsurer cannot demand notice of every occurrence that might conceivably implicate the reinsurance. Such a requirement would be administratively burdensome for the cedent and entirely unhelpful for the reinsurer. Rather, what is required is that the cedent reasonably exercises its professional judgment in noticing claims in light of the specific requirements contained in the agreement. Courts have even found it proper to admit evidence of expert testimony with regard to "timely notice" in order to give industry specific meaning to the language of an agreement's prompt notice requirement.

While late notice may be a breach of the agreement and perhaps the cedent's duty of good faith, courts remain divided as to whether the breach alone warrants the remedy of rescission. Jurisdictions fall into one of three categories with respect to late notice: (i) those requiring only that the reinsurer prove that notice was late under the terms of the agreement - the "no prejudice rule"; (ii) those requiring that a reinsurer prove prejudice due to late notice, unless prompt notice is a condition precedent to coverage; and (iii) those requiring that a reinsurer prove that it was prejudiced by untimely notice, regardless of whether notice was expressly a condition precedent to coverage.

The no-prejudice rule, once widely held, is now enforced by a minority of courts. Courts applying the no-prejudice rule effectively interpret a notice provision as condition precedent and untimely notice as a bar to recovery. The U.S. Court of Appeals for the Seventh Circuit rejected a cedent's argument that the reinsurer was precluded from denying coverage in the absence of an express designation of the notice requirement as a "condition precedent" to coverage. The court, applying Illinois law, found the notice provision did not require the reinsurer to prove prejudice in order to bar recovery. When a right is provided by contract, the court said, a deprivation of that right constitutes prejudice without any additional proof of injury. Some jurisdictions require the reinsurer to prove prejudice unless the prompt notice requirement is expressly and clearly a "condition precedent" to coverage. A condition precedent generally requires that a specified condition be fulfilled by one party before the other party becomes liable to perform. Prompt notice provisions as well as premium clauses sometimes contain such language. Given the harsh penalty for failure to fulfill a condition precedent - the denial of coverage - courts are reluctant to find a condition precedent, absent a clear and unambiguous language. Where a statement of loss and a notice requirement, for example, were contained in a single paragraph that began "As a condition precedent" the court found it ambiguous as to whether that language applied to both the statement of loss and notice requirements. Given the ambiguity, the court required the reinsurer to prove prejudice due to untimely notice.

The majority of jurisdictions require that a reinsurer prove prejudice due to untimely notice, regardless of whether notice is a condition precedent to coverage. The notice-prejudice rule squarely places the burden on the reinsurer to show damage from the cedent's failure to comply with its duties under the agreement. Moreover, damage or prejudice is defined as tangible "economic harm." It is not sufficient that a cedent allege the loss of a

right under the agreement. Many courts have established the notice-prejudice rule as a "default rule" because the harm suffered by reinsurers rarely warrants rescission of the reinsurance coverage.

A cedent's notice of an impending claim is the first opportunity a reinsurer has to exercise its right to associate. A reinsurance agreement typically contains a claims cooperation clause that grants the reinsurer a right to participate in the defense of any claim, suit or proceeding that may involve the reinsurance. The loss of this right is generally due to the cedent's untimely notice of the claim. As a result, the legal consequences for breach of a claims cooperation clause, or loss of the right to associate, follow closely on those for late notice: the reinsurer generally must show prejudice in order rescind an agreement for breach of the claims cooperation clause. If a claim of injury is based solely upon the loss of contractual rights, the reinsurer has not met its burden. The reinsurer must show it suffered "tangible economic injury" due to untimely notice or a breach of the claims cooperation clause. Despite the almost universal inclusion of claims cooperation clauses in agreements, reinsurers rarely exercise their right to associate for fear of exposing themselves to liability in excess of reinsured limits. When noticed of a questionable or potentially harmful claim, a reinsurer will often refuse to take a view of the matter, reserve its rights, and instruct to the cedent to exercise its professional judgment. This approach preserves the reinsurer's right to deny the claim while ensuring that its exposure remains within reinsured limits. As a result, courts do not give great weight to reinsurers' complaints of prejudice when they have lost their right to associate.

A cedent's breach of the claims cooperation clause or the notice provision may entitle a reinsurer to relief, even in the absence of prejudice, if it can show that the cedent acted in bad faith. Courts have routinely defined bad faith in the reinsurance context as "gross negligence or recklessness." A cedent's deliberate deception of a reinsurer constitutes bad faith. Moreover, a cedent's failure to implement basic procedures to fulfill its duties to notice and cooperate may also constitute gross negligence sufficient for a finding of bad faith. However, where a cedent has implemented routine practices and controls to ensure prompt notification but inadvertently fails to do so, the cedent has not acted in bad faith. Courts agree that a simple negligence standard in the reinsurance context would negate the prejudice requirement. Every material non-disclosure results from at least negligence, and if bad faith were equated with such negligence, no showing of prejudice would ever be required.

A claims cooperation clause that permits the reinsurer to "control" claims, sometimes called a "counsel and concur" clause, obligates the cedent to receive the consent of the reinsurer for loss settlements in order to be reimbursed. Although not commonly found in U.S. agreements, such clauses may nullify the effect of a follow the fortunes provision. Where the reinsurer has an unequivocal right to approve all settlements, the cedent's resolution of a dispute without the reinsurer's consent breaches the claims control clause. However, the reinsurer is not necessarily relieved from liability because of the cedent's breach. The cedent may still be reimbursed if it can prove the reinsurer's liability without relying upon the follow the fortunes doctrine. The cedent's breach of the claims control clause, in other words, may nullify the presumption of the reinsurer's liability following the cedent's, but it does not necessarily eliminate the possibility of liability.

It is axiomatic that insurance coverage is conditioned upon the insured's payment of premium. The failure of the cedent to pay premium, however, may not automatically cancel the reinsurance agreement. Generally, a reinsurer must take some affirmative action, including noticing the cedent of nonpayment and providing the cedent with the ability to cure, in order to cancel the agreement. Increasingly, reinsurers are including premium warranties in their agreements in order to hasten the cancellation of agreements when cedents fail to timely pay premium.
For a premium warranty to act as a condition precedent the language must clear and unambiguous. Where a cedent "warrants" equal payments at inception and periodically thereafter, and then fails to make timely payment, the agreement may terminate automatically. By contrast, an agreement simply requiring minimum and deposit premium, payable in "four equal installments," is not generally construed as a premium warranty. Premium payment is not a condition precedent to the reinsurer's liability unless the provision unequivocally states that premium is a "condition precedent" to coverage.

A reinsurer's right to offset against monies owed to an insolvent cedent for claims or unearned premium will depend upon the language of the agreement and applicable state law. Many reinsurance agreements contain a setoff clause that permits the parties to offset debts against each other and to pay only the net amount remaining. Courts in many states allow reinsurers to offset premium due against amounts owed an insolvent cedent. A reinsurer may be able enforce its right of setoff even in the absence of contractual language permitting it do so. State statutory provisions for setoff may control whether or not a specific contract so provides.

A reinsurer's obligation to indemnify a cedent for loss is generally net of any recoveries that may be had by the cedent. Most reinsurance contracts

contain a clause, typically entitled "Salvage and Recoveries," that provide that the reinsurer's obligation to pay claims is net of any recoveries by the cedent, including recoveries for salvage and subrogation. A subrogation clause in a reinsurance agreement generally permits, and sometimes requires, that a cedent seek reimbursement on account of claims and settlements that implicate the reinsurance. To benefit from such a recovery, a reinsurer may be required to demonstrate that its payment under the reinsurance agreement was clearly due to the same loss for which the subrogation rights were asserted.

Reinsurance agreements generally also contain a provision confirming the cedent's duty to assign its subrogation rights to its reinsurer. Yet, absent such a clause, a reinsurer may be deemed to have an inherent right, under equitable principles, to an assignment or enforcement of the cedent's subrogation rights. While the cedent may not have sustained a net "loss," the law generally permits it to proceed on behalf of the reinsurer to collect amounts due under the reinsurance agreement to offset or mitigate the reinsurer's loss.

Courts are divided, however, on whether the cedent alone can prosecute the subrogation action in its own name or whether the reinsurer is required to be joined in the suit as the "real party in interest." These procedural complications generally must be resolved by reference to the law of the governing jurisdiction. California law, for example, permits a cedent to pursue a subrogation action in its own name, even if entirely for the benefit of its reinsurer. Illinois law, by contrast, requires that the reinsurer be joined in the suit as the "real party in interest." While this issue is ostensibly procedural in nature, the identity of a "real party in interest" will depend on the nature of the relationship between the parties, which will be governed by reference to state substantive law.

Subrogation recoveries will be applied against loss using the "top down" methodology used in direct excess insurance (as well as excess reinsurance). This is a straightforward application of the general rule that those parties that have assumed the least risk should not be compelled to cover a loss unless those insurers with greater risk have already paid. Therefore, any recoveries are applied first to make whole those insurers that are highest in the excess layers. "One can look at subrogation recovery as reducing the net loss, in which case the excess carriers would not be obligated to pay the loss." This method of applying subrogation, the "top down" method, recognizes that an excess reinsurer is in a preferred position and is only expected to sustain a loss once the lower-level insurers' layers are exhausted.

Virtually every modern reinsurance agreement contains an "access to records clause," also called an "inspection clause" or an "audit clause." The purpose of an access to records clause is to memorialize the cedent's duty to allow a reinsurer to inspect its cedent's books and records that pertain to the business reinsured. Access to the cedent's records allows the reinsurer to make certain that a cedent is complying with the terms and conditions of the reinsurance agreement, to determine whether the loss reserves are adequate, and to identify any unreported losses that may exist. An audit of a cedent's books also permits the reinsurer to assess the skill and experience of the cedent's underwriters and claims personnel.

Modern access to records clause are highly specific as to the scope, timing, manner and method of inspection afforded a reinsurer, reflecting the increasing contentiousness in the relations between cedent and reinsurer. Whether a cedent can prevent a reinsurer from exercising its right to inspect when the reinsurer is not current on outstanding claims is a frequent point of contention. A cedent's refusal to provide a reinsurer access to its treaty records until the reinsurer pays outstanding balances has been held "commercially reasonable" where the reinsurer did not contest the amount at issue. If, however, the information the reinsurer seeks is relevant to its obligation to pay (or to the amount), the cedent's duty to provide such information is unqualified. The reinsurer's refusal to pay until provided access to certain records is not without risk, however. Courts have held that a continued refusal to object to or question billings can convert alleged losses to an "account stated."

Confidentiality within the scope of an audit or "inspection of records" is often agreed to between the cedent and its reinsurer, and the confidentiality of the inspection process has become a well-entrenched custom. However, litigation often results when a cedent discloses privileged documents in the course of an inspection or audit by a reinsurer. Whether disclosure of privileged communications to a reinsurer would constitute a waiver of privilege depends wholly upon the facts of the disclosure. One key consideration is applicability of the common interest doctrine. The "common interest" doctrine is an exception to the general rule that disclosure of privileged communications to a third party, who is not an agent or employee of counsel, waives any privilege that otherwise would apply to the communication. The timing and context of the disclosure is of paramount importance in determining whether a disclosure falls within the common interest exception.

Reinsurers often express a need for their auditors to make and retain (at least temporarily) copies of inspected documents. Cedents often seek to restrict

copying, and no court has resolved this common point of dispute. There is authority to support the view that a cedent, by permitting free and open audit access to the reinsurer, better protects itself against a rescission action by the reinsurer.

Finally, cedents often delegate their authority and duties to managing general agents (MGAs). While these duties vary according to contract, MGAs frequently underwrite the business and administer the claims in the cedent's name. In principle, a cedent is not liable for an MGA who acts outside the scope of its actual or ostensible authority. Where, however, a cedent fails to properly manage or oversee its MGA, a reinsurer may successfully disavow any liability for loss resulting from the MGA's misdeeds.

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