Is the Duty of Utmost Good Faith in Runoff?

For centuries the venerable duty of utmost good faith has served as a bedrock principle of the reinsurance industry: a standard that has set reinsurance contractual relationships apart from other commercial transactions governed by "caveat emptor."

However, a number of commentators in the industry have questioned whether the duty of utmost good faith has been in decline in our modern era. Is a reinsurer still entitled to rely in blind faith on a cedent's representations? Does a cedent still have an affirmative duty to volunteer all material facts to its reinsurer during placement? And after the contract is signed? Or must a reinsurer spend time and money investigating its cedent's representations as well as its underwriting, accounting and claims practices to verify compliance with the treaty's terms?

This article examines how today's courts and arbitration panels are interpreting and applying the duty of utmost good faith. There are relatively few court decisions examining the duty of utmost good faith, primarily because the vast majority of reinsurance contracts require the parties to resolve their differences in private arbitration. And because arbitration awards are rarely made public, and most are in any event not reasoned awards, there are few published awards that specifically address the duty's modern day application. We examine below several court decisions in recent years that have addressed the duty of utmost good faith as well as two reasoned, unanimous arbitration awards (made public in court proceedings) that examined the duty's requirements. To paraphrase Mark Twain, reports of the demise of the duty of utmost good faith are greatly exaggerated.

Court Decisions in Recent Years

As of the publication of this article, the most recent reported court opinion referencing the duty of utmost good faith is *Associated Industries Insurance Company v. Excalibur Reinsurance Corp*., 13 Civ. 8239, 2014 U.S. Dist. LEXIS 169163 (S.D.N.Y. Nov. 26, 2014). In this dispute, the cedent sought to confirm in part and vacate in part an arbitration award. For the portion it sought to vacate, the cedent alleged that the arbitration panel exceeded its authority in granting the reinsurer 10-15% discounts on some of the claims at issue. The cedent contended that the follow the fortunes doctrine obligated the panel to award 100% of each claim. Essentially, according to the cedent, if a claim was valid, the arbitrators did not possess any discretion to partially discount the amounts the cedent was entitled to receive.

In the arbitration, the reinsurer argued that deficiencies in the cedent's claims handling constituted a violation of the duty of utmost good faith. While the panel did not find those deficiencies sufficient to relieve the reinsurer of most of its liability for the claims in question, the court ruled that the panel could award a discount because the cedent "did less than it should have to meet its good faith obligation to its reinsurer." *Id.* at *20.

In response to the cedent's argument that its reinsurer was obliged to fully follow the fortunes of the cedent's deficient claims handling, the court specifically referenced the duty of utmost good faith, writing that the follow the fortunes doctrine is not "applicable where the cedent fails in its duty of good faith, which requires it to protect its reinsurer's interests as if they were the cedent's own. Reinsurers 'are protected by a large area of common interest with ceding insurers and by the tradition of utmost good faith, particularly in the sharing of information.'" *Id.* at

*14 (quoting *Unigard Sec. Ins. Co., Inc. v. North River Ins. Co.*, 4 F.3d 1049, 1054 (2d.Cir. 1993)).

In a rare case of a jury trial involving issues arising under a reinsurance contract, the court in *AXA Versicherung AG v. New Hampshire Ins. Co.,* 05-cv-10180 (S.D.N.Y. 2008) squarely addressed the obligations the duty of utmost good faith imposes on cedents. Federal District Court Judge Jed Rakoff issued the following jury instruction:

> All parties who enter into contracts have a duty not to misrepresent the material, or important, facts and, more generally, to operate in good faith toward one another. But because reinsurers are not involved in underwriting the underlying policies (that is, in investigating the risks and negotiating the terms of the underlying policies), a primary insurer owes a particular duty to his reinsurer to disclose to the reinsurer those facts, known to the insurer but unlikely to be known to the reinsurer, that are "material," that is facts that a reasonable insurer understands that a reasonable reinsurer would need to know to assess the risks of the reinsurance. This duty to disclose is sometimes referred to as the duty of "utmost good faith," but what it really comes down to is the continuing duty of an insurer in these circumstances and under these conditions to disclose these material facts to the reinsurer even if the reinsurer has not asked for them.

The jury found in favor of the reinsurer, rescinding the reinsurance treaties and awarding punitive damages as well.

On appeal, however, the Second Circuit reversed the lower court's decision, holding that despite the cedent's fraudulent conduct the applicable New York statute of limitations barred the reinsurer's rescission claim:

> We hold that [the reinsurer] was confronted with a clear "storm warning" in August 1998, as well as additional facts through 2000, "such as to suggest . . . the probability that [it] ha[d] been defrauded," thereby triggering a duty of inquiry. AXA's failure to engage in that inquiry imputed to it knowledge of the alleged fraud and renders its fraudulent inducement claims time barred.

In recent years, two notable arbitration awards addressing the obligations imposed by the duty of utmost good faith have been made public in court filings.

AXA Versicherung AG v. N.H. Ins. Co., 391 Fed. Appx. 25, 29 (2d Cir. 2010) (internal citations omitted). The primary "storm warning" referenced by the court was the addition of language to the final draft of the treaty wordings which were signed by the lead underwriter's deputy that arguably would have tipped off the reinsurer to the fraudulent scheme. The broker did not bring to the deputy's attention the newly added sentence (in an article where, the reinsurer argued at trial, one would never have expected to find it) and instead, the reinsurer argued at trial, led the deputy to believe that all modifications to the final wording had been brought to the reinsurer's attention and had been approved. The deputy testified that she did not notice the added sentence to the wordings. However, the court did not expressly address the duty of utmost good faith and instead focused on a contracting party's duty to read thoroughly a contract before signing.

In the past two years, a pair of court decisions have addressed the requirements of the duty of utmost good faith in the context of late notice of claims. In most states, a reinsurer is required to demonstrate that it was prejudiced by the cedent's late notice. In these two recent decisions, however, courts have held that the reinsurer is entitled to relief without a showing of prejudice if it can demonstrate that its cedent acted in bad faith or failed to act in accordance with its duty of utmost good faith.

In *Ins. Co. of the State of Pa. v. Argonaut Ins. Co.*, 12 Civ. 6494, 2013 WL 4005109 (S.D.N.Y. Aug. 6, 2013), the reinsurer was relieved of its burden to prove it was prejudiced by late notice by demonstrating that the cedent acted in bad faith by not providing timely notice. The court wrote that: "While recognizing that the modern relationship of reinsurers and their reinsureds may no longer be characterized by utmost good faith, the Second Circuit (in *Unigard*, cited above), nevertheless concluded that …"a very high level of good faith – whether or not designated 'utmost' – is required to ensure prompt and full disclosure of material information without causing reinsurers to engage in duplicative monitoring."' 4 F.3d at 1054. In the late notice context, this means that a cedent must implement "routine practices and controls to ensure notification to reinsurers." *Id*. at 1070. Notably, the *Argonaut* court held that there need not be "deliberate deception" for a reinsurer to be relieved of its burden of proving prejudice. 2013 WL 4005190 at *13.

In *Granite State Ins. Co. v. Clearwater Ins. Co.*, 09 Civ. 10607, 2014 WL 1285507 (S.D.N.Y. March 31, 2014), where the cedent failed to give its reinsurer notice of claims until after those claims had already been settled – and the reinsurer had a right to associate in the control of claims - the court held that such notice after settlement was untimely. *Id*. at *19. The court also ruled that "no reasonable jury could conclude that Granite State met its duty of utmost good faith" when it entered into settlements without notifying Clearwater. The court relieved the reinsurer of any liability for the settlement without requiring the reinsurer to prove prejudice.[1]

Arbitration Awards Addressing the Duty of Utmost Good Faith

In recent years, two notable arbitration awards addressing the obligations imposed by the duty of utmost good faith have been made public in court filings. The first is a 2007 unanimous 40-page arbitration award issued by three highly respected reinsurance arbitrators in a

[1] The case is currently under appeal.

Utmost Faith (continued)

reinsurance dispute between the same ceding companies which were parties to the jury trial before Judge Rakoff (discussed above) and another of their reinsurers on the same business.

> Although a reinsurer cannot ignore obvious errors or omissions in the cedent's disclosures, and will not be allowed to rely on them, reinsurers are not required to evaluate reinsurance submissions under the assumption that they are other than complete and accurate. In other words, reinsurance is not and cannot be a game of "Hide-and-Seek", or "20 Questions", where the reinsurer is required to review the cedent's submission with a suspicious mind, or the investigative powers of a Sherlock Holmes, to ferret out the truth. Said another way, reinsurance provides no safe haven for the maxim caveat emptor or even sharp practices that are more common in other business relations. To the contrary, reinsurance is a business that requires and needs utmost good faith, and that starts with the cedent in its submission to prospective reinsurers.

In re Arbitration Between New Hampshire Ins. Co., et al. and Lloyd's Syndicate 435/D.P. Mann, Aug. 31, 2007. Among a long list of improper acts, the ceding companies' broker had failed to disclose to the reinsurer's representative that crucial language had been added to the contracts, and the panel condemned that maneuver as a violation of the duty of utmost good faith:

> As part of the implementation plan, [the cedents' London broker] put some pressure on [the reinsurer's] contract wording specialist, without contacting the underwriter to whom the business was broked, and without identifying let alone explaining the change – which in London is pejoratively termed a "pick up". Without noticing the unexplained change, [the reinsurer's] contract wording specialist executed the contracts on behalf of [the reinsurer] within days. The cedents' broker did not identify let alone explain to the reinsurers the major change to what it knew and had told [the cedent and the US broker] was the broke.

Id. The panel awarded the reinsurer rescission *ab initio*. Notably, in contrast to the Second Circuit's "storm warning" ruling, the panel did not find that the unannounced inclusion of language in the final treaty wording "should have" been caught by the reinsurer.

In a 2012 arbitration involving the same parties to the jury trial before Judge Rakoff, the reinsurer brought claims for post-contract formation breaches of contract and fraudulent acts. The highly experienced 3-member panel unanimously ordered the cedents to refund overbilled claims that had been improperly "grossed up" (for example, in one year increasing the reinsurer's treaty participation from 20% to nearly 73%, which obviously greatly reduced the cedents' net retention for claims in the working layer). While the panel did not refer expressly to the duty of utmost good faith when it roundly criticized the actions of the cedent and its agent, it made reference to the cedents' duty to communicate material facts – here, the grossing up - clearly to its reinsurer and found that the cedents' agents had made "confusing, indeed perplexing written communications" that relieved the reinsurer of any obligation to investigate such clues to uncover the grossing up. In awarding the reinsurer $1 million of exemplary damages, the panel explained its reasoning:

> The evidence in this arbitration is overwhelming that time after time [the cedent] opted for the obscure and imprecise communication rather than the clear and the explicit … They dealt with the most fundamental aspect of this reinsurance relationship, *i.e.* the nature of the reinsurance transaction and the participation therein.

In re Arbitration Between New Hampshire Ins. Co. and AXA Verischerung AG, July 27, 2012.

Conclusion

As one commentator has written, the duty of utmost good faith means that that "one party cannot, without cause, take actions to elevate its interest above those of the other." Robert M. Hall, *Utmost Good Faith in the Reinsurance Relationship,* robertmhall.com, 2014. While this duty may evolve as the industry itself changes, recent court opinions and published arbitration awards demonstrate that the duty of utmost good faith is still being enforced with vigor both in courts as well as arbitrations and remains a cornerstone of the reinsurance industry. ●

Joseph T. McCullough and Peter B. Steffen, Partners, Freeborn & Peters LLP. jmccullough@freeborn.com, psteffen@freeborn.com