Reinsurance Contracts and the Role of Fiduciary Duty

By Gerard V. Mantese and Mark C. Rossman

> For when they insure, it is sweet to them to take the monies; but when disaster comes, it is otherwise and each man…strives not to pay.[1]

Introduction

The concept of reinsurance, or "insurance for an insurer,"[2] has existed since the fourteenth century, when northern Italian shipping merchants used it to spread the risk of insuring ships.[3] Today, reinsurance is a widely accepted mechanism that insurers use "to spread the risks on policies they have written or…reduce required reserves," which allows the ceding insurer to "possess more capital to invest or use to insure more risks."[4]

The typical reinsurance agreement involves an arrangement in which one insurer (the reinsured) transfers, or "cedes," all or part of the risk that it has underwritten to another insurer (the reinsurer).[5] The Michigan Court of Appeals has defined the reinsurance contract as one "whereby one insurer for a consideration contracts with another to indemnify it against loss or liability by reason of a risk which the latter has assumed under a separate and distinct contract as the insurer of a third person."[6] The transaction involves the cedent paying a premium to the reinsurer, in return for which the reinsurer agrees to indemnify the cedent as to a defined portion, or layer, of the financial exposure on the policies that the cedent issues to its own insureds.

In recent years, reinsurance has been the subject of increasing federal court litigation, which often addresses the existence and extent of any fiduciary and good-faith duties ancillary to this contractual relationship.[7] As discussed below, reinsurers sometimes seek elimination of their contractual obligations to indemnify based on various arguments.

The Reinsured Has a Fiduciary Duty to the Reinsurer

Michigan jurisprudence on the standards that govern the reinsurance relationship is not extensive. However, when the Michigan Supreme Court last opined on the issue in 1926, it held in *Columbian Nat Fire Ins Co v Pittsburgh Fire Ins Co*[8] that the reinsured "occupied a fiduciary position demanding fairness and open disclosure," and noted that the parties to the reinsurance transaction "were not dealing at arm's length."[9] The Court held that this fiduciary position demanded not only "fairness," but, more specifically, the "open disclosure of all reinsurance reducing its agreed retention of risks."[10] An intentional failure to disclose

these risks to the reinsurer "constituted a fraud in the eye of the law," rendering the reinsurance "void," and entitling the reinsurer to recover its payments on the losses incurred.[11]

This notion of the reinsurance relationship being governed by fiduciary principles of fairness and open disclosure is consistent with the widely accepted view in the federal case law that under the principle of *uberrimae fidei,* or "the utmost good faith," parties to a reinsurance contract are held to the highest standards of conduct.[12] One federal court noted that "bad faith tactics [are] wholly alien to the usual course of dealings between an insurer and a reinsurer," and that the reinsurance relationship is one between "partners."[13]

Various federal cases have imposed a duty of disclosure on the part of the ceding insurer, consistent with the Michigan Supreme Court's holding in *Columbian National.* The duty generally requires disclosure of the facts necessary to assess the risk that the reinsurer will assume under the contract. For example, in *Unigard Securities Ins Co, Inc v North River Ins Co,*[14] the Second Circuit Court of Appeals held:

> [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 "utmost"—is required to ensure prompt and full disclosure of material information without causing reinsurers to engage in duplicative monitoring.[15]

In another decision, the Second Circuit held that a reinsured owes the reinsurer "utmost good faith, requiring the reinsured to disclose to the reinsurer all facts that materially affect the risk of which it is aware and of which the reinsurer itself has no reason to be aware."[16] Likewise, the First Circuit held that a reinsured was required "to exercise good faith and to disclose all material facts," because it had "the power to impose significant risks and liabilities" upon the reinsurer.[17]

In addition to the duties associated with disclosure of material facts relating to the risk that is ceded, courts outside of Michigan have held that the cedent must also exercise good faith relative to the handling and settlement of the claim for which it hopes to be indemnified.[18] Generally speaking, these holdings provide that a reinsured's liability determinations are not insulated from challenge by the reinsurer if they are "fraudulent, in bad faith, or the payments are 'clearly beyond the scope of the original policy' or 'in excess of [the reinsurer's] agreed-to exposure.'"[19]

The available remedy for a failure to disclose or otherwise act in good faith can be harsh. In *Columbian National,* the Michigan Supreme Court held that the reinsurer would be entitled to recover the losses it paid out based on an intentional nondisclosure.[20] In *Compagnie de Reassurance d'Ile de France v New England Reins Corp,* the District Court of Massachusetts noted that "the trend in…modern cases has been to recognize *uberrimae fidei* [utmost good faith] as the traditional operative standard, but to interpret it to require rescission of reinsurance contracts only where the reinsured acted in bad faith or where the reinsurers suffered prejudice from a failure to disclose."[21]

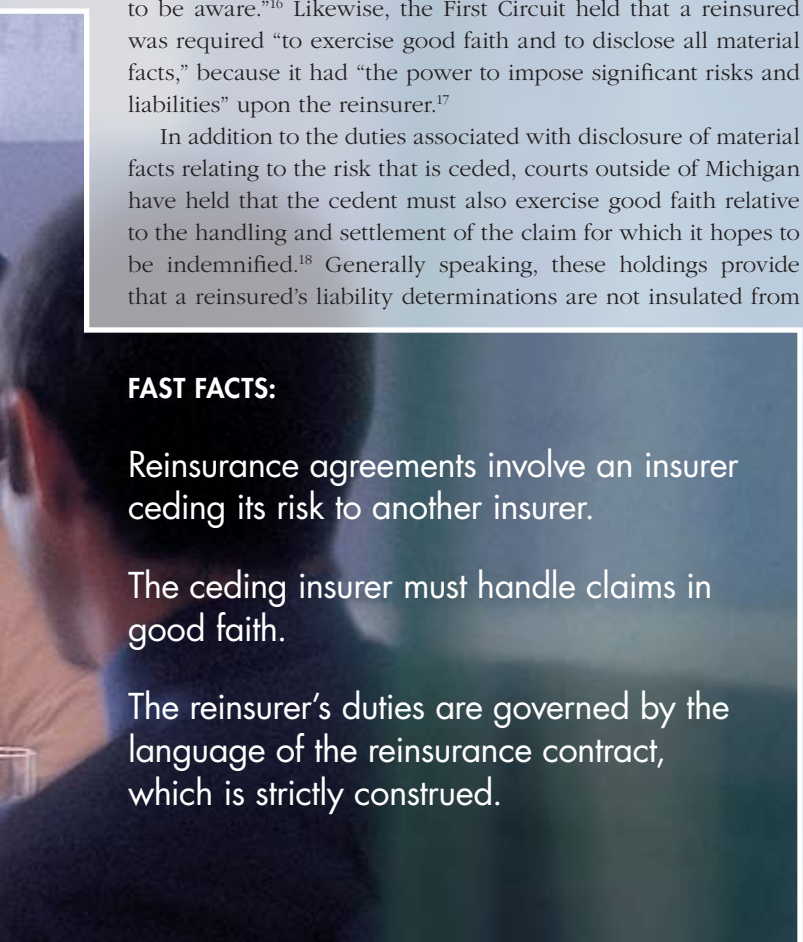
The Reinsurer's Duties are Governed by the Reinsurance Contract

In contrast to the duties of the reinsured, the reinsurer's primary obligation is much more straightforward—i.e., to indemnify the loss of the cedent, absent bad faith, fraud, or nondisclosure. Under Michigan law, this obligation appears to be governed not by *uberrimae fidei* or fiduciary duty, but by the language of the reinsurance contract. The Michigan Court of Appeals took up the question of a reinsurer's indemnity obligations in the 1990 case of *Michigan Millers Mut Ins Co v North Am Reins Corp,*[22] wherein the court held that the duty was governed exclusively by the terms of the reinsurance contract:

> The extent of the liability of the reinsurer is determined by the language of the reinsurance contract, and the reinsurer cannot be held liable beyond the terms of its contract merely because the original insurer has sustained a loss.[23]

In the 1999 case of *Michigan Twp Participating Plan v Federal Ins Co,*[24] the Michigan Court of Appeals employed a constructionalist approach to contract interpretation and application, rejecting the reinsured's argument that the "follow-the-fortunes" doctrine applied in the absence of a contractual provision providing as such. The follow-the-fortunes doctrine requires "a reinsurer…to indemnify for payments reasonably within the terms of the original policy, even if technically not covered by it."[25] Put another way, it "binds a reinsurer to accept the cedent's good faith decisions on all things concerning the underlying insurance terms and claims against the underlying insured: coverage tactics, lawsuits, compromise, resistance or capitulation."[26] Essentially, the follow-the-fortunes doctrine (if it applies per the terms of the reinsurance contract) saddles the reinsurer with the obligation to cover the cedent's loss within the ceded layer, even if it was not a covered loss pursuant to the underlying policy.

With strong language,[27] the *Michigan Twp* court refused to read the follow-the-fortunes doctrine into a reinsurance contract and thereby impose a duty to indemnify beyond that which is explicitly set forth in the contract.[28] This holding is consistent with the more recent mandates of the Michigan Supreme Court regarding contract interpretation in the *Rory* and *Devillers* decisions.[29]



FAST FACTS:

Reinsurance agreements involve an insurer ceding its risk to another insurer.

The ceding insurer must handle claims in good faith.

The reinsurer's duties are governed by the language of the reinsurance contract, which is strictly construed.

Thus, it appears that while the reinsured bears duties arising out of the contract, as well as common law fiduciary and good-faith duties, the primary duty of the reinsurer (to indemnify) is limited to what the contract language provides.

Conclusion

While the precise contours of the reinsured's fiduciary duties have not been explored or addressed in Michigan jurisprudence since *Columbian National,* the holding that a reinsured party "occup[ies] a fiduciary position demanding fairness and open disclosure" remains good law, and it invokes the plethora of consistent federal case law discussing the obligations that arise under the principle of *uberrimae fidei.* Thus, in Michigan, as elsewhere, reinsurers have available to them a host of claims and defenses based on, inter alia, bad faith, breach of fiduciary duty, fraud, nondisclosure, and recklessness that can be raised in the event that the reinsured has not fully disclosed material facts or properly managed the claims as to which the underlying losses have occurred. In contrast, the reinsurer's duties seem to be based solely on the terms of the contract, pursuant to the holdings in *Michigan Millers* and *Michigan Twp.* ■

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FOOTNOTES

1. Iris Origo, *The Merchant of Prato: Francesco di Marco Datini,* 1335–1410 (New Hampshire: Nonpareil Books, 2002), p 139.
2. *Travelers Cas and Sur Co v Constitution Reins Corp,* 2004 WL 2387313 at * 1, n 2 (ED Mich, 2004) (J. Cohn).
3. Edwin W. Kopf, *Notes on Origin and Development of Reinsurance* (New York City: Globe Printing Company, Inc., 1929), p 26.
4. *Michigan Twp Participating Plan v Federal Ins Co,* 233 Mich App 422, 427 (1999), lv den 461 Mich 945 (2000) (quoting *Colonial Am Life Ins Co v Comm'r of Internal Revenue,* 491 US 244, 246 (1989)); *Unigard Sec Ins Co, Inc v North River Ins Co,* 4 F3d 1049, 1053 (CA 2, 1993) (citing Bart C. Sullivan, *Reinsurance in the Age of Crisis,* 38 Fed'n Ins & Corp Couns Q 3, 4 (1987)).
5. See, e.g., Ostrager & Newman, Handbook on Insurance Coverage Disputes (12th ed), § 15.01[a] ("[r]einsurance is a contractual arrangement whereby one insurer (the ceding insurer) transfers all or a portion of the risk it underwrites pursuant to a policy or group of policies to another insurer (the reinsurer)") (citing *Colonial Am Life Ins Co,* 491 US at 244).
6. *Michigan Millers Mut Ins Co v North Am Reins Corp,* 182 Mich App 410, 413 (1990) (citing 13A Appleman, Insurance Law & Practice, § 7693, p 523).
7. *Compagnie de Reassurance d'Ile de France v New England Reinsurance Group,* 944 F Supp 986, 993 (D Mass, 1996) ("[R]einsurance litigation has become more common, and in many such cases courts have been called upon to explicate the precise contours of the *uberrimae fidei* duty") (citations omitted), rev'd on other grounds 57 F3d 56 (CA 1, 1995), cert den 516 US 1009 (1995).
8. *Columbian Nat Fire Ins Co v Pittsburgh Fire Ins Co,* 236 Mich 243, 248 (1926).
9. *Id.* at 248 (1926).
10. *Id.*
11. *Id.* at 247–248.
12. See, e.g., *Commercial Union Ins Co v Seven Provinces Ins Co, Ltd,* 217 F3d 33, 43 (CA 1, 2000) cert den 531 US 1146 (2001); *Compagnie De Reassurance D'Ile De France, 57* F3d at 72; *Christiana Gen Ins v Great Am Ins Co,* 979 F2d 268, 280–281 (CA 2, 1992).
13. *Commercial Union,* 217 F3d at 43–44 (citing *Commercial Union Ins Co v Seven Provinces Ins Co,* 9 F Supp 2d 49, 69 (D Mass, 2000)); but cf. *Continental Cas Co v Stronghold Ins Co, Ltd, 77* F3d 16, 21–22 (CA 2, 1996) (noting that "[a]lthough it has been said that the relationship between a reinsured and its reinsurer is not technically a fiduciary one…centuries of history have treated both as allies rather than adversaries") (citations omitted); *Christiania General,* 979 F2d at 280 ("[B]ecause these [reinsurance] contracts are usually negotiated at arms length by experienced insurance companies…there is no reason to label the relationship as 'fiduciary'") (citation omitted).
14. *Unigard Sec Ins Co, Inc v North River Insurance Company,* 4 F3d 1049 (CA 2, 1993).
15. *Id.* at 1069 (citing Restatement (Second) of Contracts § 205 (1981)).
16. *Christiania,* 979 F2d at 278 (citing *Sun Mut Ins Co v Ocean Ins Co,* 107 US 485, 510 (1887)).
17. *Compagnie De Reassurance, 57* F3d at 73.
18. See, e.g., *Suter v General Accident Ins Co of Am,* 2006 WL 2000881 at * 26–27 (D NJ, 2006) (reinsurer not required to "follow the settlements" of the reinsured due to gross negligence and bad faith on the part of the reinsured because it "did not make [a] reasonable, businesslike investigation and determination as to whether heart valve claims should have been allowed"); *Am Employers' Ins Co v Swiss Reins Am Corp,* 413 F3d 129, 137 (CA 1, 2005) (reinsurer is free to challenge whether underlying settlement was reasonable and in good faith).
19. *The North River Ins Co v Ace Am Reins Co,* 361 F3d 134, 140 (CA 2, 2004).
20. 236 Mich at 247.
21. 944 F Supp at 994; See also *Gerling Global Reins Co–US Branch v Ace Property & Cas Ins,* 2002 WL 1770725 at *2 (CA 2, 2002) (holding that "[n]ondisclosure of…material facts 'renders a reinsurance agreement voidable or rescindable'") (quoting *Michigan Nat'l Bank–Oakland v Am Centennial Ins Co,* 674 NE2d 313, 319–320 (NY, 1996).
22. 182 Mich App 410.
23. *Id.* at 413–414.
24. 233 Mich App 422.
25. *Christiania,* 979 F2d at 280 (citation omitted); *Mentor Ins Co (UK) Ltd v Brannkasse,* 996 F2d 506, 517 (CA 2, 1993) (follow-the-fortunes doctrine "simply requires payment where the cedent's good-faith payment is at least arguably within the scope of the insurance coverage that was reinsured").
26. *British Int'l Ins Co v Seguros La Republica, SA,* 342 F3d 78, 85 (CA 2, 2003).
27. 233 Mich App at 430–431.
28. But cf. *Nat Amer Ins Co of Cal v Certain Underwriters at Lloyd's of London,* 93 F3d 529, 536 (CA 9, 1996) (holding that "custom and usage" could be a basis for implying "follow the settlements" clause in policy). For further discussion of how other courts have handled the issue of whether or not a follow-the-fortunes clause is implied in reinsurance contracts, see 44A Am Jur 2d Insurance § 1822 (May 2006) and 3 Law and Prac of Ins Coverage Litig § 41:27 (June 2006); James A. Johnson, *Gentlemen's agreement: What practitioners should know about reinsurance,* 81 Mich B J 20 (August 2002).
29. *Rory v Continental Ins Co,* 473 Mich 457, 468 (2005) ("A fundamental tenet of our jurisprudence is that unambiguous contracts are not open to judicial construction and must be *enforced as written,*" and holding that unambiguous contractual provision providing for a shortened period of limitations is to be enforced as written, regardless of reasonableness) (emphasis in original); *Devillers v Auto Club Ins Ass'n,* 473 Mich 562, 582 (2005) ("[C]ontractual-language must be enforced according to its plain meaning, and cannot be judicially revised or amended to harmonize with the prevailing whims" of the Court, and holding that statutory one-year-back limitation is not subject to judicial tolling).