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The Reinsurance Contract – New Appleman on Insurance Law Library Edition, Chapter 72

Posted by LexisNexis Insurance Law Community Staff

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Chapter 72 discusses basic principles related to the formation and terms of reinsurance contracts. The chapter begins by considering the manner in which reinsurance contracts are formed as well as the documents that can evidence such a contractual arrangement. The chapter then continues with a discussion of rules applicable to the construction and interpretation of reinsurance contracts.

Section 72.01 addresses the creation and contents of reinsurance contracts. This section starts, in Section 72.01[1], with a discussion of the role that industry custom and practice may play in connection with both how a reinsurance relationship comes into being and how a reinsurance contract is interpreted. As noted in Section 72.01[1][a], notwithstanding that reinsurance contracts often involve substantial exposures, such a contract can - consistent with industry custom and practice - be based on a single-page "slip" that outlines only the most basic details of the parties' relationship. Section 72.01[1][b] describes the use of standard and manuscripted terms in reinsurance contracts. In facultative reinsurance contracts, it is common to incorporate standard terms from the insurance policy issued by the cedent to the underlying insured. In treaty reinsurance contracts, on the other hand, the parties may employ standard terms, manuscripted terms, or some combination of both. In addition, as discussed in Section 72.01[1][c], industry custom and practice may provide a basis for implying terms into a reinsurance contract, regardless whether that contract consists only of a slip or is based on more formal wording.

Section 72.01[2] looks at the process of forming a reinsurance contract. At the outset, Section 72.01[2][a] explains that, unlike the typical case involving direct insurance, both parties to a reinsurance contract generally are sophisticated entities. As a result, the rule of construction under which ambiguities are construed against the drafter of a direct-insurance policy (*i.e.*, the insurer) typically does not apply to reinsurance contracts. Section 72.01[2][b] goes on to describe how a lead underwriter may act on behalf other reinsurers participating in a reinsurance contract. Indeed, a lead underwriter may have the authority to modify a contract and approve claim payments on behalf of following reinsurers. As addressed in Section 72.01[2][c], an intermediary may act on behalf of one or more parties to a reinsurance contract. A cedent frequently will retain a broker to act as the cedent's agent in procuring reinsurance coverage. Similarly, a reinsurer may appoint a managing general underwriter to assume reinsurance business on the reinsurer's behalf.

Section 72.01[3] examines the contents of reinsurance contracts. Section 72.01[3][a] first emphasizes that, like other contractual arrangement, a reinsurance contract is formed by an offer and acceptance that establish a meeting of the parties' minds together with the provision of appropriate consideration. As detailed in Section 72.01[3][b], a reinsurer's acceptance of a placement slip creates a binding reinsurance contract. A slip usually contains just the essential elements of parties' contract, such as the type of risk, the sum and limit reinsured, the cedent's retention, and the premium to be paid to the reinsurer. The reinsurer commonly will signify its acceptance by signing the slip (a practice known as "scratching" in the London market) or issuing a binder confirming the reinsurance terms. While a cedent's broker aims to obtain full participation in a reinsurance contract, there are occasions when the broker secures commitments that exceed 100%. In that situation, the broker will "write down" the reinsurers' percentages pro rata so that the total subscription equals 100%. Section 72.01[3][c] discusses the effect of formal reinsurance wording and the interaction between such wording and a slip to which the parties originally agreed. As Section 72.01[3][d] explains, a reinsurance contract may be amended by agreement of the parties through an endorsement or rider. Finally, Section 72.01[3][e] cautions that one should not confuse a placement slip and a cover note. While a slip may evidence a binding reinsurance contract, a cover note usually represents only an indication from a broker to the cedent that reinsurance has been placed as directed. Accordingly, a reinsurer generally is not bound by a cover note.

Section 72.02 deals with the construction and interpretation of reinsurance contracts, beginning with an analysis of the

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relationship between the rules applicable to the interpretation of reinsurance contracts to the rules applicable to the interpretation of direct insurance policies. This section goes on to analyze the presumptions made in the reinsurance contract, the significance of the slip, and incorporation of other terms into the reinsurance contract. It then addresses key provisions commonly found in reinsurance contracts, conditions and warranties, issues surrounding choice of law, and ends with a discussion of terms that may be implied into reinsurance contracts.

Section 72.02[1] addresses the relationship between rules of interpretation that are commonly applied to direct insurance policies, asking if and when those same rules will be applied in the context of a reinsurance contract. The discussion begins, in Section 72.02[1][a], with basic contract principles. As a contract between sophisticated commercial entities, any interpretation of a reinsurance contract must begin with the application of general contract principles. One begins with the language of the contract itself. Only if that language is ambiguous, should one look to extrinsic evidence, which might include the drafting history, industry custom and practice, the intent of the parties, and the purpose of the contractual relationship.

A discussion is had of the doctrine of *contra proferentum*, a doctrine commonly applied in the interpretation of direct insurance policies, whereby any ambiguity is resolved against the insurer and in favor of the insured party. Section 72.02[1][b] addresses the majority rule, whereby the doctrine of *contra proferentum* is not applied in the context of reinsurance contracts. The minority rule is discussed as well, explaining the rationale used by one jurisdiction in its determination that *contra proferentum* applies with equal force in the context of a reinsurance contract.

Section 72.02[1][c] deals with additional concepts that apply in the direct insurance context. In the reinsurance context, most courts will recognize that the parties to a reinsurance relationship are sophisticated commercial actors and that the protective rules applied in the context of direct insurance are simply unnecessary. This section then draws back to the basic rules of contract interpretation as they are typically applied between equally sophisticated parties.

Certain presumptions that apply in the reinsurance context are addressed in Section 72.02[2]. As with any commercial contract, most courts will apply a standard of good faith and fair dealing to all parties to the reinsurance contract. This standard is addressed in Section 72.02[2][a], along with a brief discussion of the instances where a tribunal might apply the higher standard of utmost good faith to the reinsurance relationship. Section 72.02[2][b], then, discusses the importance of custom and practice in the reinsurance context.

Section 72.02[3] addresses the significance of the slip in the construction and interpretation of the reinsurance contract. Section 72.02[3][a] addresses the situation where the slip is the only written document establishing the reinsurance relationship, and issues that arise in interpreting the slip as the contract. When there is a written document following the slip, the terms of the slip might be used to aid interpretation if the terms of the final written document are ambiguous; this situation is discussed in Section 72.02[3][b]. Section 72.02[3][c] goes on to address the situation where a term on the slip is absent from the final written document.

Incorporation of terms is discussed in Section 72.02[4]. Specific considerations for the incorporation of underlying documents and terms are addressed in section 72.02[4][a]. This section includes a discussion of *HIH Casualty & General Insurance v. New Hampshire Insurance Company*, where the London appellate tribunal laid out the considerations for determining whether a specific term should be incorporated into the reinsurance contract. Section 72.02[4][b] lists the various forms of incorporation, including incorporation by reference to a market form, to an underlying policy or contract, or to other specific documents in existence when the reinsurance contract is formed. This portion ends with a discussion of the incorporation of specific clauses in Section 72.02[4][c]. This section addresses the difference between terms that are relevant to the risk and terms that are merely collateral. Specific clauses addressed include forum selection clauses, jurisdiction clauses, choice of law provisions, and arbitration agreements.

Sections 72.02[5] and [6] reviews the key provisions common to reinsurance agreements that collectively define and delineate the nature and scope of the indemnification obligations assumed by the reinsurer and the corresponding duties of the reinsured and reinsurer of critical importance to their relationship. The terms addressed include those relating to the structure and scope of the reinsurance (*e.g.*, Business Written, Ultimate Net Loss, Limits and Retention, Exclusions, and Extra-Contractual Obligation Clauses), terms relating to the duties of the parties in the event of a loss or claim under the reinsurance (e.g. Follow the Fortunes/Follow the Settlements, Notice and Right to Associate, and Access to Records Clauses) and provisions relating to enforcement of the contract and obligations in the event of the insolvency of the reinsured (*e.g.*, Arbitration, Service of Suit, Security and Insolvency Clauses). Sections 72.02[5] and [6] also address variations on these common clauses that serve to clarify, alter or expand the scope of the reinsurance and the balance of duties owed between the parties, and court decisions that influence the application of the contract terms in practice.

One of the critical first steps in reaching a proper legal interpretation of any reinsurance contract is accurately determining which jurisdiction's law will govern the resolution of any legal dispute. In Section 72.02[7], the application and interpretation of choice of law issues as it relates to reinsurance contracts is discussed. This section confirms that if a reinsurance contract has an express choice of law provision, providing for the application of a particular jurisdiction's law to any disputes arising under the reinsurance contract, courts will virtually always enforce this provision.

In Section 72.02[7][a], it is emphasized that in determining the appropriate choice of law resolution, the practitioner must first confirm the nature of the legal dispute in which the potential choice of law dispute arises. If the choice of law issue concerns a matter of substantive law, there are different issues which need to be considered than if the issue concerns a matter of procedural law. In any event, the reinsurance practitioner is cautioned that in the context of arbitration, arbitrators sometimes view themselves as not bound by the strict rules of law and elect not to make any formal choice of law determination.

In Section 72.02[7][b], the manner in which a choice of law determination is made in the absence of an express choice of law provision, for a substantive law issue is discussed. While each jurisdiction has its own rules and guideposts for making a determination about which substantive law will apply to a reinsurance contract, the clear majority of jurisdictions focus on factors that attempt to define which jurisdiction has the most "substantial relationship" to the contract dispute at issue. The law of the jurisdiction with the most "substantial relationship" to the contract issue is then applied. Other jurisdictions have their own variants on these same basic factors, with California leading a handful of jurisdictions that engage in a choice of law analysis based on a "governmental interest" test.

It may be just as important in a reinsurance dispute for a practitioner to determine which procedural law might apply to the proceeding resolving any dispute arising from a reinsurance contract than which substantive law will apply. Fortunately, as discussed in Section 72.02[7][c], it is usually much easier to determine the applicable procedural law. Again, if the reinsurance contract expressly provides for a particular procedural law to govern, the courts will usually enforce those provisions. If there is no express provision discussing the relevant procedural law, most often, the procedural law that applies to the particular tribunal before which the reinsurance dispute is being resolved will be the governing procedural law. As a result, if a reinsurance dispute is being resolved before a federal court in the United States, the Federal Rules of Civil Procedure will govern all matters of procedure. However, since most reinsurance disputes are resolved by arbitration, the relevant procedural law is one addressing arbitration procedure. For the clear preponderance of reinsurance disputes in the United States, the procedural law that will apply to reinsurance arbitration will be the Federal Arbitration Act. Indeed, even if the reinsurance contract expressly provides for the application of a particular state arbitration act, that procedural law may be pre-empted by the Federal Arbitration Act.

Not all relevant terms of a reinsurance contract may be found in express provisions. In fact, some of the more significant duties and responsibilities of a reinsurance contract may actually be implied. In Section 72.02[8], a few of the commonly implied, or potentially implied, terms will be discussed.

One of the most frequently discussed implied terms arising from reinsurance contracts are the doctrines of "follow the fortunes" and "follow the settlements." A majority of courts considering whether "Follow the Fortunes" or "Follow the Settlements" are implied in any reinsurance contract have concluded that, absent specific custom and practice evidence showing otherwise, these concepts are not implied as a matter of law. The exceptions to this majority are discussed in Section 72.02[8][a]. Those few courts that have found that the "follow the fortunes" and "follow the settlement" doctrines can be implied in a reinsurance contract where an express "follow the fortunes" or "follow the settlements" clause is not explicitly present have done so when presented with sufficient evidence of an industry custom and practice or a particular course of dealing between the contracting parties.

There is wide support for concluding that a reinsured has an implied obligation to conduct claim investigations and handling in a "businesslike" manner. Failure of a reinsured to act in a "businesslike" manner can deny the reinsured the ability to require a reinsurer to "follow the fortunes" or "follow the settlements" of the reinsured. As discussed in Section 72.02[8][b], however, the specific contours of this implied obligation are not very clearly defined and require factually intensive considerations.

Although some have argued for the implied obligation of a reinsured to retain net some portion of a risk being reinsured, the courts have not supported this obligation arising from an implied term. This is primarily because of the common use of express retention warranties in the reinsurance industry when such an obligation exists. But, as cautioned in Section 72.02[8][c], a reinsured must be very cautious about disclosing its intent to not hold any portion of the risk net. Failure of the reinsured to disclose a decision to not hold any portion of the risk net has been held to support a claim for recession by the reinsurer.

It is also widely held that a reinsured has an implied obligation to provide its reinsurer access to its documents and information regarding the subject matter of the reinsurance contract. As part of the overall implied obligation of utmost good faith, a reinsured must place the reinsurer in the same position to fully appreciate and understand the nature of the risks being covered by the reinsurance contract. As Section 72.02[8][d] explains, failure by the reinsured to disclose relevant and material information may support a claim by the reinsured that the reinsurance contract should be rescinded. This implied obligation does not cease at the time of underwriting a contract. The reinsured continues to have an implied, if not express, obligation to continue to afford the reinsurer with access to and information concerning the claims being handled sufficient to allow the reinsurer to appreciate and understand that potential for liability that may be faced under the reinsurance contract. Often times the scope of this obligation is expressly detailed in access to records clauses of reinsurance contracts. However, even in the absence of such a clause, the reinsured will have an implied obligation to provide access to documents and information concerning the subject of the reinsurance contract.

* * *

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