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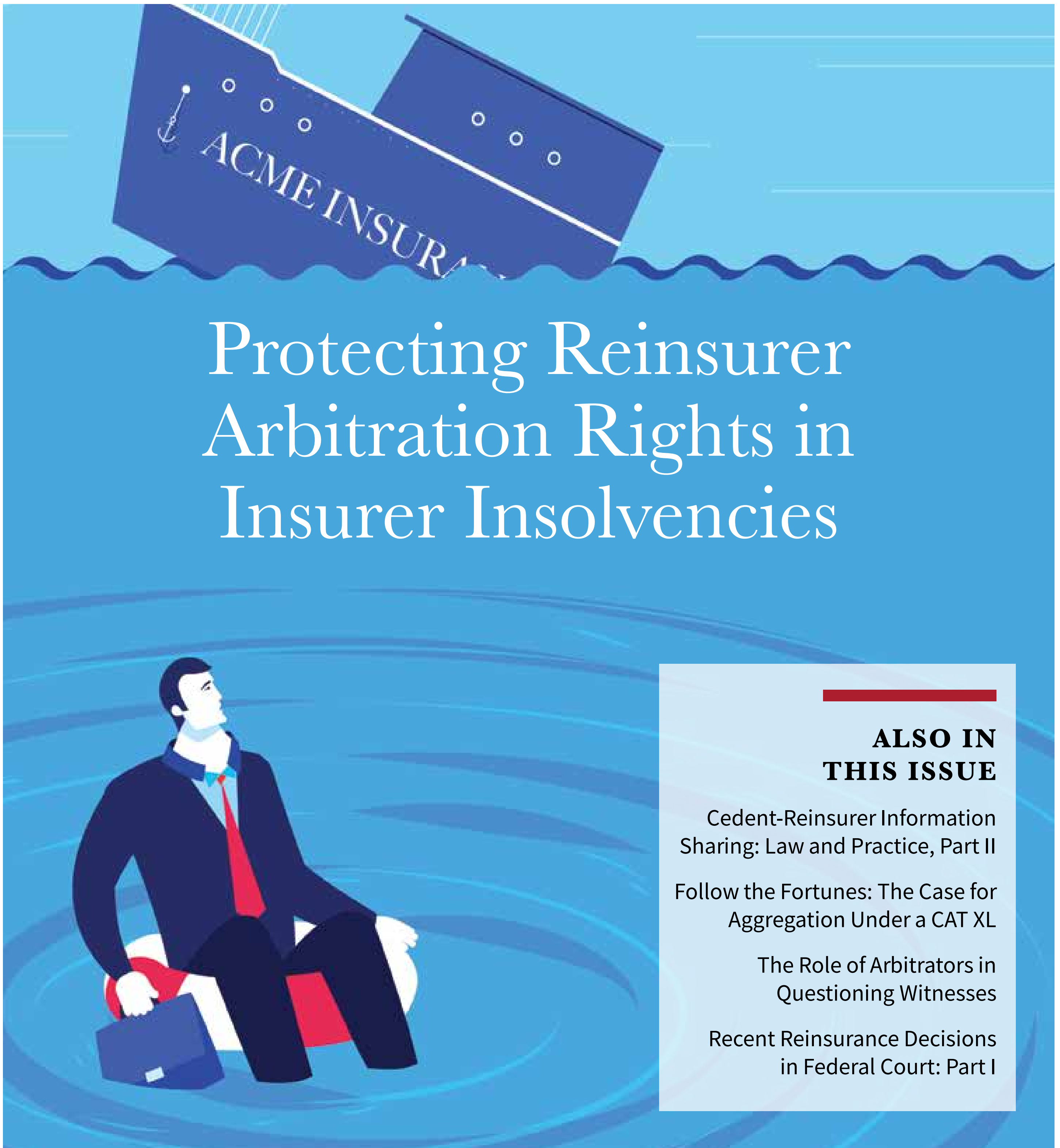

Protecting Reinsurer Arbitration Rights in Insurer Insolvencies

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Follow the Fortunes: The Case for Aggregation Under a CAT XL

By Curtis B. Leitner and Larry P. Schiffer

Across global reinsurance markets, reinsurers and cedents are negotiating—and, in some cases, litigating or arbitrating—the cession of substantial COVID losses under catastrophe excess-of-loss reinsurance treaties ("CAT XLs"). Anecdotally, a substantial number of these losses fall under event and travel cancellation and business interruption policies. The disputes are largely about aggregation—pooling individual losses into a single "loss occurrence" for purposes of retention and indemnity limits. A significant fault line in these debates is whether cedents can aggregate losses across jurisdictional lines (for example, business interruption resulting from March 2020 closure orders in New York, New Jersey, and Connecticut).

Although much has been written on COVID-related aggregation disputes, an important aspect of these disputes has not received adequate attention: the follow-the-fortunes doctrine. Depending (as always) on the specific contract language at issue, the follow-the-fortunes doctrine can provide a powerful argument in support of multi-jurisdictional aggregation. This article describes the state of play in the aggregation debate, unpacks the follow-the-fortunes doctrine, and then suggests how cedents can take advantage of it in aggregation disputes.

Aggregating COVID Losses Under a CAT XL

The loss occurrence definition of a CAT XL typically permits the aggregation of a series of losses arising from one "event" or "catastrophe" during a fixed period of time (e.g., 168 hours). For most cedents, COVID losses likely fall within the high limit for a loss

occurrence under a CAT XL. Thus, cedents generally want to aggregate as many COVID losses as possible into one loss occurrence to exceed the retention and maximize their reinsurance recovery. To that end, cedents have proposed broadly defined "events" that span multiple jurisdictions, such as the outbreak of COVID across countries, continents, or even the entire world. Meanwhile, to reduce claim payouts, reinsurers have tried to confine COVD-related "events" to a single jurisdiction, such as losses caused by a closure order in one state or country.

The argument usually runs something like the following: Reinsurers invoke a well-known U.K. court precedent stating that an "event" is "something which happens at a particular time, at a particular place and in a particular way" [1]. Cedents respond that other jurisdictions have broader definitions of an "event" and, in any case, U.K. precedents also state that the meaning of *event* "must take colour from the contractual context, including the perils insured against" [2]. In the CAT XL context, where hurricanes, wildfires, and earthquakes are the paradigmatic "events," cedents insist that an "event" must be construed broadly.

Reinsurers reply that, in the U.K. Financial Authority's test case on business interruption policies, the U.K. Supreme Court held that an "outbreak" of COVID is not an "event" [3]. Cedents counter that the test case was decided in the context of retail business interruption policies that insure entirely different risks than a CAT XL—for example, vermin or clogged drains at one restaurant. The thrusts and parries over the "loss occurrence" definition go on and on.

Lost in this debate are the background interpretive principles that govern how to construe and apply a reinsurance contract. For example, it has been suggested that cedents should invoke "honorable engagement" provisions in CAT XLs, which allow arbitrators to decide disputes based on commercial reasonableness rather than a strict reading of contract language [4]. The follow-the-fortunes doctrine is another interpretive principle that has been under-utilized in the debate.

Unpacking the Follow-the-Fortunes Doctrine

A follow-the-fortunes clause of a reinsurance contract reads something like, "It is the intention of this contract that the fortunes of the reinsurer shall follow the fortunes of the [cedent]." This provision memorializes the general principle that the "insurer and reinsurer should have a shared destiny; the reinsurer must live with the calamities and fortuities that give rise to claims under the original risk insured" [5]. Although (again) the particular contract language always controls, it is helpful to analyze the follow-the-fortunes doctrine as an umbrella concept that includes two overlapping principles: (1) the original risk principle and (2) the follow-the-settlements principle. Each principle may be memorialized in more specific contract language.

Under the original risk principle, the reinsurer is bound by the underwriting fortunes of the cedent. The "doctrine burdens the reinsurer with those risks which the direct insurer bears under the direct insurer's policy covering the original insured" [6]. These original "risks" include both the risk of claims predicated on insured perils and the risks involved in the underwriting process—e.g., the number of policies written, the premium collected, and the credit risk associated

"Lost in this debate are the background interpretive principles that govern how to construe and apply a reinsurance contract."

with those premiums. Reinsurance contracts often memorialize the original risk principle, at least for specific contract language, in a follow-form clause, which "incorporates by reference all the terms and conditions of the reinsured policy" [7].

Several examples illustrate the application of the original risk principle. If an insurance policy requires payment in a particular currency, and the price of the currency spikes when payment is due, the reinsurer, like the cedent, must live with the increased cost. If the local law governing an underlying casualty policy unexpectedly changes to allow punitive damages, and thereby increases the cedent's exposure, the reinsurer must share in that exposure [8]. To take a COVID example, if a cedent litigates with its policyholder over whether COVID caused "physical damage" under a property policy, the reinsurer is bound by the court's construction of the policy.

Under the follow-the-settlements principle, the reinsurer is bound by the settlements (or, as they sometimes are called, the actions) of the cedent regarding claims on underlying policies. The follow-the-settlements principle is typically memorialized in specific contractual language stating that the reinsurer is bound by the settlements of the cedent so long as they are within the scope of the reinsurance contract. This principle "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" [9].

> "Under the original risk principle, the reinsurer is bound by the underwriting fortunes of the cedent."

To bind the reinsurer, the cedent's interpretation of the underlying policy must be reasonable and businesslike. The follow-the-settlements principle facilitates settlements and promotes coverage. Without it, a cedent could not settle a policy without risking that the reinsurer would relitigate all the defenses the cedent raised, or could have raised, in litigation with the policyholder.

Limits of the Follow-the-Fortunes Doctrine

The follow-the-fortunes doctrine is subject to the express limitations of a reinsurance contract. For example, the New York Court of Appeals holds that a follow-the-fortunes clause "does not alter the terms or override the language of reinsurance policies" [10]. From a European perspective, the Principles of Reinsurance Contract law similarly state that the "follow-the-fortunes rule will not expand coverage under the contract of reinsurance" and that "the reinsurer is only required to follow the reinsured's fortunes, insofar as a claim is covered under the contract of reinsurance" [11].

Suppose an insurance policy expressly states that it does not cover punitive damages. The cedent is subject to a judgment in a wrongful death suit of $1 million of compensatory damages and $100 million of punitive damages. The cedent settles with the victim's estate for $10 million while the judgment is on appeal. Because the settlement obviously includes mostly punitive damages, the reinsurer is not bound by the settlement to the extent that it includes punitive damages that are expressly excluded by the reinsurance contract [12].

Yet to say that the follow-the-fortunes doctrine does not override the language of a reinsurance contract is not to say that the doctrine is irrelevant to the interpretation of a reinsurance contract. The First Circuit got it right when it explained that "[o] f course, if sufficiently clear, specific limits in the [reinsurance] certificate control over the general aim of concurrence and ordinary 'follow' clauses" [13]. But that is a very big "if," especially in the context of the current unprecedented pandemic. When the language of a reinsurance contract is vague or ambiguous and thus not

sufficiently clear to resolve a dispute, the follow-the-fortunes doctrine may be relevant to the interpretation of the disputed provision.

Follow-the-Fortunes Doctrine in Action

A prominent First Circuit decision demonstrates how the follow-the-fortunes doctrine can be determinative of an ambiguous provision in a reinsurance contract. In *Commercial Union Insurance Co. v. Swiss Reinsurance America Corp.* [14], the court construed the term "occurrence" in several three-year facultative certificates. The certificates reinsured the cedent's liability under several three-year excess-of-loss property policies. The certificates required the reinsurer to pay a portion of the cedent's liability under the excess policy for "each occurrence"—i.e., "50 percent of [the cedent's] first $1 million in loss for 'each occurrence'" [15]. The reinsurance certificates had typical follow-form and follow-the-settlement clauses. The question was whether the liability limit for an "occurrence" applied separately to each year during the three-year period covered by a certificate or applied to the entire three-year period.

The policyholder sustained serious property damage losses relating to hazardous waste pollution (including leaking chemicals) at various sites. The reinsurer took the position that continuing leakage at each site during a certificate's three-year duration was one "occurrence." In this view, if a certificate provided that the reinsurer was liable for 50 percent of the first $1 million loss per occurrence, the reinsurer's liability would be capped at $500,000 per site. The cedent took the position that the liability cap applied anew each year. On this view, the reinsurer would be liable for $500,000 for each year of a three-year policy period, or $1.5 million per site.

The First Circuit found that the pertinent language in the reinsurance certificates—namely, "each occurrence"— was "simply cryptic as applied to continuing leaks over a multi-year period under a multi-year policy" [16]. Neither party pointed to relevant extrinsic evidence. In the end, the court ruled that what "ma[de] the difference" was the follow-form and follow-the-settlement clauses [17].

Unlike the reinsurance certificates, the excess-of-loss policies defined an "occurrence," but they were ambiguous as to whether the limit for an "occurrence" applied annually or for the duration of a policy. On the one hand, the excess policies defined "occurrence" as "repeated exposure to substantially the same general conditions existing at or emanating from one premises location," which could easily encompass ongoing leakage over three years [18]. On the other hand, the excess policies had follow-form clauses incorporating the terms of the underlying insurance policies, which "explicitly provided for their per occurrence limits to apply on an annual basis" [19].

The cedent reached a settlement with the policyholder that assumed "that the $5 million per-occurrence limit in each policy should be viewed as applying separately to each policy year, i.e., $15 million for a three-year policy" [20]. Because the meaning of "occurrence" was ambiguous in the excess-of-loss policy, the court found that the cedent's settlement was reasonable.

The First Circuit applied the follow-the-fortunes doctrine to ascertain the meaning of "occurrence" under the certificates:

Under Swiss Re's follow-the-settlements clause it is bound to accept [the] pro-annualization reading of the Commercial Union policy for purposes of establishing Commercial Union's liability to Grace. In our view, Swiss Re's follow-the-form clause should be deemed to extend this reading into the parallel language in

> "There is no precedent for a once-in-a-lifetime pandemic."

Swiss Re's own certificates, subject only to any clear limitation to the contrary in the Swiss Re documents [21].

The "general aim of concurrence" between the reinsurance contract and the reinsured policy, based on the original risk principle, "tipped [the balance] in favor of making [the reinsurer] share liability on a basis that conforms its liability to that of the cedent where the cedent has settled reasonably and in good faith" [22].

> "Background interpretive principles like the follow-the-fortunes doctrine are a vital part of the context of a reinsurance contract."

The Aggregation of COVID Losses Revisited

The key provision in the "loss occurrence" definition of a CAT XL—i.e., a series of losses arising from an "event," a "catastrophe," or the like—does not clearly state whether and how it applies to government closure orders or an outbreak of COVID. There is no precedent for a once-in-a-lifetime pandemic, and there is unlikely to be extrinsic evidence that directly bears on this issue. CAT XL treaties, however, often contain language that memorializes (in some form) the follow-the-fortunes doctrine. As in *Commercial Union*, that doctrine can tip the balance in favor of the cedent's position.

Begin with an example that is precisely analogous to *Commercial Union*. Suppose an excess-of-loss policy has an aggregation clause that applies to a series of travel or event cancellations that arise from one "event," "catastrophe," or the like. Suppose further that the cedent reasonably settles the policyholder's claims based on the assumption that the same "event" caused losses in at least three countries. If a reinsurer refuses cover and argues that the term "event" in the reinsurance contract is limited to a government closure order or outbreak of COVID in a single jurisdiction, the cedent could respond with a *Commercial Union* argument. Specifically, the follow-the-settlements principle binds the reinsurer to the cedent's interpretation of "event" in the excess-of-loss policy, and the original risk principle extends that interpretation to the parallel language in the reinsurance contract.

A similar argument holds when the reinsured policy does not have a parallel aggregation clause. Suppose a CAT XL covers numerous retail business interruption policies similar to those addressed in the UK Financial Authority's test case (i.e., policies that cover business interruption caused by a disease within a certain radius of the business). Many CAT XLs provide an open-ended definition of "loss occurrence" that applies to all perils that are not specifically excluded. If the CAT XL does not include a disease exclusion (which was less common before COVID), then it covers COVID-related risk. Thus, the original risk principle burdens the reinsurer with the COVID-related risks in the underlying policies, subject to clear limitations in the reinsurance contract.

Again, a CAT XL loss occurrence provision does not clearly limit the reinsurer's exposure to losses in one jurisdiction. In fact, two of the five judges in the U.K. test case would have held that an "occurrence" in a narrow retail business interruption policy includes "the pandemic disease as a whole" [23]. Of course, the majority disagreed (and viewed the "occurrence" as an individual infection). But surely the three-two split on the U.K. Supreme Court demonstrates that it is at least reasonable to interpret an "event" as the "disease as a whole," which includes a multi-jurisdictional outbreak.

Among competing reasonable interpretations of a loss occurrence provision, the original risk principle favors the interpretation that promotes the "general aim of concurrence" between a CAT XL and the risks covered by the underlying policies [24]. An interpretation that encompasses

a multi-jurisdictional COVID outbreak does just that. Unlike a certificate of facultative reinsurance that reinsures one underlying policy, a CAT XL treaty reinsures numerous underlying policies that often provide cover in numerous different jurisdictions. If the business reinsured by a CAT XL treaty includes, for example, business interruption policies throughout various states in the Northeastern United States, a reinsurer cannot be "liable on a basis that conforms its liability to that of the cedent" if aggregation were limited to one jurisdiction [25]. Thus, the follow-the-fortunes doctrine tips the balance in favor of multi-jurisdictional aggregation.

Remember Background Principles and Contractual Context

When cedents analyze their loss occurrence provisions and the case law construing an "event" or "catastrophe," they should not lose sight of the forest for the trees. Background interpretive principles like the follow-the-fortunes doctrine are a vital part of the context of a reinsurance contract. Depending on the specific language at issue, they can provide a strong argument in support of a cedent's aggregation position.

NOTES

1 *Axa Re v Field* [1996] 1 W.L.R. 1026 at p.1035, per Lord Mustill.

2 *Kuwait Airways Corp. v. Kuwait Ins. Co. SAK* [1996] 1 Lloyd's Rep 664, 684-85, per Justice Rix.

3 *Financial Conduct Authority v. Arch et al.* (2021), para 69.

4 "GC urges clients to use 'honourable engagement' principles to counter reinsurers' Covid aggregation objections." 2021. *The Insurer*, June 15.

5 Ostrager, B., and M.K. Vyskocil. 2000. *Modern Reinsurance Law and Practice*. Little Falls, N.J.:Glasser LegalWorks.

6 *Bellefonte Reinsurance Co. v. Aetna Cas. & Sur. Co.*, 903 F.2d 910, 912 (2d Cir. 1990).

7 *Aetna Cas. & Sur. Co. v. Home Ins. Co.*, 882 F. Supp. 1328, 1345 (S.D.N.Y. 1995).

8 These two examples are drawn from "Principles of Reinsurance Contract Law (PRICL) 2019," Article 2.4.3, Comments C7-C8. Published by the Project Group on Principles of Reinsurance Contract Law in cooperation with the International Institute for the Unification of Private Law. H. Heiss, M. Schauer, and M. Wandt, eds.

9 *N. River Ins. Co. v. Ace Am. Reinsurance Co.*, 139–40 (2d Cir. 2004).

10 *Travelers Cas. & Sur. Co. v. Certain Underwriters at Lloyd's of London*, 96 N.Y.2d 583, 596, 760 N.E.2d 319, 328 (2001).

11 PRICL, Article 2.4.3, Comment C9.

12 *Am. Ins. Co. v. N. Am. Co. for Prop. & Cas. Inc.*, 697 F.2d 79, 80 (2d Cir. 1982).

13 *Commercial Union Insurance Company v. Swiss Reinsurance America Corp.*, 413 F.2d 121, 128 (1st Cir. 2005).

14 413 F.2d 121 (1st Cir. 2005).

15 *Id.* at 123.

16 *Id.* at 128.

17 *Id.*

18 *Id.* at 123

19 *Id.* at 126 (emphasis in original).

20 *Id.* at 124.

21 *Id.* at 128 (emphasis added).

22 *Id.* at 128 (emphasis added).

23 *Financial Conduct Authority v. Arch et al.* (2021), para 323.

24 *Commercial Union Insurance Company*, 413 F.2d at 128.

25 *Id.*

Curtis Leitner is counsel at Morvillo Abramowitz Grand Iason & Anello PC.

Larry Schiffer is the editor of the ARIAS·U.S. *Quarterly*, a past chair and current member of the ARIAS·U.S. Technology Committee, a member of the ARIAS·U.S. Ethics Discussion Committee, and a recipient of the ARIAS·U.S. Dick Kennedy Award.