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Expert Analysis

# The Time Has Come for the Court Of Appeals to Resolve Reinsurance Issue

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The U.S. Court of Appeals for the Second Circuit's reinsurance decision last month in *Global Reinsurance of America v. Century Indemnity*, 15-2164-cv (Dec. 27, 2016) (*Global*), will finally lead to resolving the unsettled question about whether reinsurers will have limitless liability for an underlying insurer's legal costs. The final answer to this question could have a profound impact on the obscure but important reinsurance business. After deciding *Bellefonte Reinsurance v. Aetna Casualty & Surety*, 903 F.2d 910 (2d Cir. 1990) and *Unigard Security v. North River Ins.*, 4 F.3d 1049 (2d Cir. 1993) in favor of limiting reinsurers' liability for costs, the Second Circuit in *Global* finally decided it was time for the N.Y. Court of Appeals to weigh in on this significant reinsurance question, and the *Global* court certified that question to New York's high court.[1] The brokerage companies obtaining reinsurance certificates to primary insurers hope that New York's high court will finally lay all litigation expenses at the reinsurance companies' doorstep. On Jan. 10, 2017, the N.Y. Court of Appeals accepted the certified question and set a briefing schedule.

## Background

Mention "reinsurance" and many lawyers head for the exits. Reinsurance is insurance on insurance. It allows a primary insurance company to spread its liability risk to reinsurers who charge a premium to the primary insurer to issue a reinsurance certificate. Reinsurance should be distinguished from excess insurance, which is an insurance policy that pays only when the primary policy limits are exceeded. A reinsurer agrees to reimburse the primary insurer for a proportionate share of the primary insurer's liability payments. This reimbursement is ostensibly limited to the liability limits in the reinsurance certificate.

The question for the *Global* court was whether the underlying liability insurer's expenses and costs—even if they exceed the reinsurer's limits of liability—could be passed on to the reinsurer? In *Global*, the "reinsured" or primary liability company was Century Indemnity. As the reinsured company, Century, in reinsurance lingo, was the "cedent" company. Global was the "reinsurer." The reinsurance certificates issued by Global to Century covered specific Century policies rather than providing blanket reinsurance coverage. Thus, the reinsurance was "facultative" reinsurance.

The Century liability policies had insured Caterpillar Tractor decades ago. In 1988, thousands of lawsuits were filed against Caterpillar alleging bodily injury from asbestos exposure. Century and Caterpillar then became embroiled in a coverage dispute. Caterpillar won the coverage dispute, and Century became obligated to pay Caterpillar's defense costs even though they were in excess of the liability limits. Ultimately, Century paid

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$60 million to Caterpillar and agreed to pay $30.5 million in the future. About 90 percent of this $90 million was Century's defense costs, and only 10 percent represented indemnity payments made to asbestos plaintiffs. Moreover, a significant portion of those attorney costs were Century's payments to its lawyers in its coverage dispute with Caterpillar.

In *Global*, Century argued that despite the liability limits in Global's reinsurance certificates, Global was obligated to proportionately reimburse Century for Century's defense costs even though Global's share of the costs, when added to Global's liability payments to Century, would exceed the liability limits in Global's reinsurance certificates. Century asserted that because Global's certificates had accepted all terms and conditions of the Century liability policies, and because under those terms and conditions Century was liable to Caterpillar for costs and expenses beyond the Century liability limits, Global was liable to Century for its share of costs and expenses, regardless of Global's reinsurance liability limits.

Liability insurance policies handle defense costs in different ways, depending on the type of policy. Many policies do not charge defense costs against the policies' liability limits. Others, such as professional liability policies, usually include defense costs in calculating policy limits. Still others with high retention limits may not provide for covered defense costs at all. Regardless of the coverage, a liability policy will define how defense costs and related expenses will be treated.

Reinsurance certificates are not insurance policies and do not contain the same lengthy definitions and exclusions. They are usually only several pages. Historically, the concept of reinsurance goes back centuries to English maritime insurance when less was written down and more was done on a handshake. The reinsurance certificates in *Global*, summarized here in part for brevity, stated, "[t]he liability of Global … shall follow that of Century and, except as otherwise provide herein, shall be subject in all respects to all the terms and conditions of the underlying insurance policy." The certificates also provided that Century's settlements would be proportionately binding on Global and "in additional thereto, in the ratio that Global's loss payments bears to Century's gross loss payments, [Global's] proportion of expenses, other than [Century's] salaries and office expenses, incurred by [Century] in the investigation and settlement of claims or suits."

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In *Global*, the Second Circuit thought it was time to take another look at its conclusion in *Bellefonte*. Questioning its prior decision, the *Global* court said: "[W]e find it difficult to understand the *Bellefonte* court's conclusion that the decision in that case unambiguously capped the reinsurer's liability for both loss and expenses." The *Global* court said that the language of the *Bellefonte* reinsurance certificate, similar to that in the *Global* certificate, was unclear about what "Reinsurance Accepted" meant. The court said evidence of custom and practice would have been helpful in *Bellefonte*, but no evidence had been offered. Nevertheless, in *Global* several experts had submitted affidavits as part of the Appendix on appeal stating that the Global reinsurance liability limit would not, as a matter of customary business practices, place a limit on the reinsurance to pay expenses associated with the claim.

The *Global* court concluded that both reinsurers and insurers had compelling arguments about the consequences of either continuing the holdings of *Bellefonte* and *Unigard* or reexamining and possibly overruling those holdings. The Second Circuit recognized that changing now the level of risk borne by the parties would adversely affect those reinsurers who had issued certificates in the past under a set of assumptions that were reflected in the reinsurers' premiums. On the other hand, as urged by reinsurance brokers submitting amici briefs, to allow reinsurers to escape liability for amounts above the reinsurance certificate liability limit would create large gaps in reinsurance coverage an insurer would expect to receive.

The *Global* court did not believe the N.Y. Court of Appeals decision in

*Excess Ins. v. Factory Mutual Ins.*, 3 N.Y.3d 577 (2004), controlled its decision. In *Excess*, the primary insurer had sued the reinsurer to recover litigation costs the primary insurer had paid in litigation with its own policyholder over a first party property damage claim. In other words, unlike in *Global*, which involved litigation expenses incurred in defending an insured against liability claims, *Excess* involved litigation expenses of the primary insurer in a coverage fight with its insured. While the Second Circuit in *Global* said this distinction left the question before it unanswered, the N.Y. Court of Appeals in *Excess* relied upon the Second Circuit's decisions in *Bellefonte* and *Unigard*, both decisions with third-party liability policies, to create what appeared to be a blanket rule that the liability cap in a reinsurance certificate limited the reinsurer's liability for litigation expenses to the liability limit amount.

Ultimately, the *Global* court decided that rather than adhere to prior decisions possibly containing bad law, it would certify to the N.Y. Court of Appeals the question whether New York law "imposes either a rule of construction, or a strong presumption, that a per occurrence liability cap in a reinsurance contract limits the total reinsurance available under the contract to the amount of the cap regardless of whether the underlying policy is understood to cover expenses such as, for instance, defense costs?"[2]

## Court of Appeals

It seems fairly certain that the N.Y. Court of Appeals will not find on the certified question that a reinsurer is required to reimburse the ceding liability insurance company for the ceding company's legal costs fighting its own insured. These costs are not expenses customarily associated with liability coverage, are not listed in the underlying policy language, and therefore should not be considered a known risk undertaken by the reinsurer when issuing its certificate.

Defense costs related directly to defending Caterpillar against asbestos claims is a more difficult question. The reinsurance certificate referenced by the *Global* court (there were several certificates with similar language) does not state that the certificate's liability limit create a ceiling for its payment to the ceding insurer for litigation expenses paid by the ceding insurer. But it also does not state that litigation expenses are exempt from the liability limit.

As suggested by Judge Robert Reed in his *Essex* dissenting opinion, a court cannot determine as a matter of law in all cases that a liability limit in a reinsurance certificate applies to legal expenses—just because holding otherwise would leave the reinsurer exposed to more liability than it thought it would be taking on. The reinsurance certificate in *Global* was ambiguous, a determination that should have been made as a matter of law. The litigants would be required to resolve this ambiguity by proof of extrinsic evidence surrounding the issuance of the reinsurance certificate and by proof of the custom and practice in the reinsurance industry.

Because of Century's duty to defend Caterpillar, it was required under the liability policies to pay legal expenses, even expenses exceeding Century's policy liability limits. The Global reinsurance certificate reads that the "liability of the Reinsurer … shall follow that of the Company, and, except as otherwise specifically provided herein, shall be subject in all respects to all the terms and conditions of the Company's Policy." This ambiguous language of the certificate could mean that Global would be responsible for proportionally reimbursing Century for Century's payment of legal expenses for the insured, and, as with the Century policy, Global's reimbursement for those legal expenses is not limited by the reinsurance liability limits. The *Global* court—understandably—found that it was time for a reexamination by the state's highest court of the Second Circuit's prior holdings, holdings which now may be in jeopardy.

1. N.Y. Court of Appeals Rule 500.27 and Local Rule 27.2 of the Second Circuit Rules.

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