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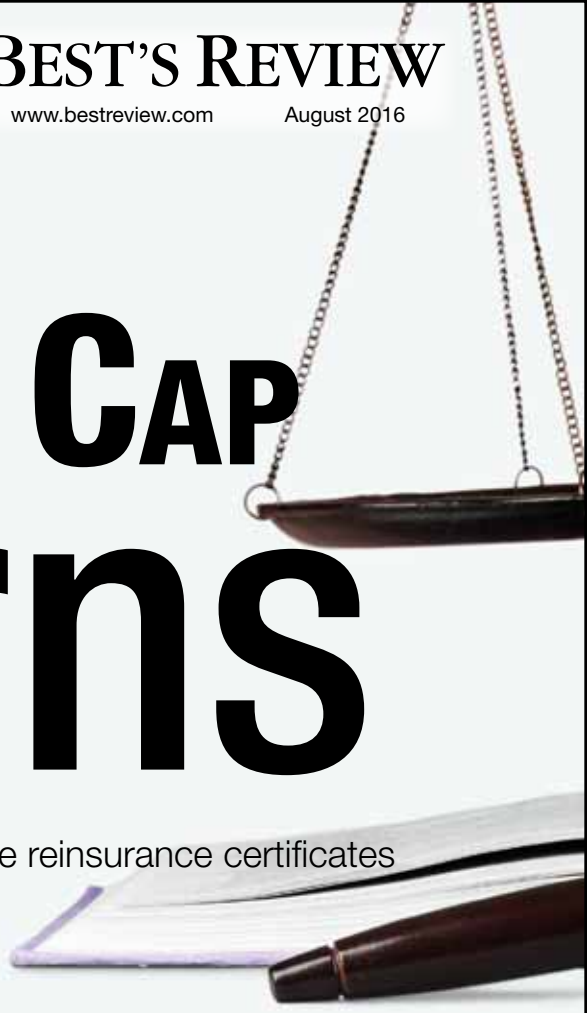
Reinsurance: Legal

The Bellefonte Cap Returns



The issue of how to treat expenses under facultative reinsurance certificates is again before a federal court of appeals.

by Edward K. Lenci and Scott M. Seaman

The Bellefonte Cap, a shorthand reference to the limit on reinsurers' obligations under facultative reinsurance certificates, is before the 2nd U.S. Circuit Court of Appeals once again, and the outcome of the current case could cost reinsurers millions of dollars and lead to big changes in how ceding companies and reinsurers do business.

The cap stemmed from a 1990 decision by the 2nd Circuit in the case of *Bellefonte Reinsurance Co. v. Aetna Casualty & Surety Co*. By way of background, beginning largely in the 1990s and continuing through the early 2000s, the issue of whether there was reinsurance coverage for a ceding company's declaratory judgment costs—i.e., expenses associated with litigating coverage issues with direct policyholders—was one of the most hotly contested issues between ceding companies and their reinsurers. Although the issue of indemnity for declaratory judgment costs under reinsurance contracts occasionally arises in reinsurance arbitrations, it has largely been resolved within the industry.

It is the related issue of whether expenses are payable within or in addition to reinsurance limits, particularly under facultative reinsurance certificates—which also has been subject to many disputes over the past quarter century—that continues to vex the industry. In some respects, this issue is the reinsurance equivalent of "wasting limits" versus "supplementary payments" in the direct insurance arena without any defense obligation on the part of reinsurers. As with most reinsurance disputes, the starting point is the language of the reinsurance contract itself. Such disputes generally center on whether the "reinsurance accepted" limit of a facultative certificate constitutes a limit on the reinsurer's obligation to reimburse a ceding company for expenses paid in addition to the limits of the certificate.

The Bellefonte Cap

In *Bellefonte*, the 2nd Circuit decided that the monetary amount of "reinsurance accepted" set forth on the face of fairly common reinsurance facultative certificates capped the reinsurer's obligations, even with respect to the ceding company's litigation expenses and costs in the underlying dispute, which can prove astronomical in many matters. Stated differently, under *Bellefonte*, the stated limits represent the maximum amount the reinsurer must pay regardless of whether

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the cession involves expenses, loss, or a combination of the two. The facultative certificates in *Bellefonte* provided that the reinsurer was bound by the settlement of underlying claims and "in addition thereto" was bound also to pay "its proportion of expenses … incurred by [the ceding company] in the investigation and settlement of claims or suits." The 2nd Circuit rejected the argument that the "in addition" language means that expenses are payable in addition to limits.

Bellefonte stirred heated debate back in the 1990s, and it remains news today. This is in no small part because the 2nd Circuit hears appeals from, among other federal district courts, the U.S. District Court for the Southern District of New York, which is located in Manhattan, a major center of the reinsurance business. As such, 2nd Circuit decisions are viewed by many as having a somewhat greater impact on the reinsurance business.

Understandably, many ceding companies have been critical of the *Bellefonte* decision. Although garnering the support of many reinsurers, some have refused to adhere to it, even though the 2nd Circuit's decision may be to their economic benefit, principally because some contend it is contrary to industry custom and practice.

Bellefonte has been followed by most, but not all, decisions within the 2nd Circuit over the past 26 years, and courts in other jurisdictions have followed it. The Bellefonte Cap is not universally applied, however. For example, decisions of the U.S. Courts of Appeals for the 4th and 8th Circuits have held that reinsurers are obligated to reimburse ceding companies for defense costs paid in addition to loss. In general, courts rejecting *Bellefonte* have taken a different view of the "in addition" language or have relied upon evidence of industry custom and practice.

Key Points

The Background: A 1990 decision by the 2nd U.S. Circuit Court of Appeals imposed a cap on a reinsurer's obligations under reinsurance facultative certificates, even with respect to the ceding company's litigation expenses and costs in the underlying dispute.

What's Happening Now: The 2nd Circuit in early May heard argument in an appeal that involves the Bellefonte Cap. The lower court followed *Bellefonte* and decided in favor of the reinsurer.

The Bottom Line: The outcome of the case could cost reinsurers millions of dollars and lead to big changes in how ceding companies and reinsurers do business.

The Current Case

As noted earlier, the issue is before the 2nd Circuit once again. In early May, the 2nd Circuit heard argument in an appeal in the case of *Global Reinsurance Corp. of America v. Century Indemnity Co*. That case involved a claim by a ceding company that its facultative reinsurer must pay a share of more than $60 million in expenses the former incurred in an asbestos litigation even though the "reinsurance accepted" sections of the nine facultative certificates at issue had

amounts ranging from $250,000 to $2 million. The lower court followed *Bellefonte* and decided in favor of the reinsurer. An appeal to the 2nd Circuit followed.

The reinsurer's argument for affirmation of the lower court's decision is straightforward: The language of the facultative certificate in question is substantially similar to that in *Bellefonte*, the court should not extend the limits of the reinsurance contract, and *Bellefonte* constitutes binding precedent that has been widely followed. The argument for reversal of the lower court's decision was vigorously asserted not only by the ceding company but also by certain reinsurance brokers who filed a friend of the court brief.

In their brief, the brokers posited a number of arguments seeking not just reversal of the lower court's decision but also an end altogether to *Bellefonte*. They argued that the lower court was wrong to hold that the reinsurer's obligation to pay its share of those defense costs is always limited because the provisions of each of the certificates in question provided that it follows the terms of the reinsured policy. They argued also that, when a facultative reinsurer agrees to assume a share of a policy, it is agreeing to take on its share of all of the risks covered by that policy, and that the premium the reinsurer receives is calculated accordingly. The brokers argued, too, that the outcome of the case in the lower court led to an unfair windfall for the reinsurer. Further, they contended that the Bellefonte Cap, in general, undermines the risk transfer function of facultative reinsurance. By leaving the cedent's payments of defense costs completely unreinsured, they suggested, too, that the solvency of cedents may be threatened.

As with all things related to the Bellefonte Cap, the predictions as to what the 2nd Circuit will rule vary considerably. Some believe the 2nd Circuit will adhere to *Bellefonte*. Others, pointing to the more recent but officially unpublished 2nd Circuit decision in *Utica Mutual Ins. Co. v. Munich Reinsurance America Inc.*, predict that the 2nd Circuit may change course. In *Utica Mutual v. Munich Re*, the 2nd Circuit reviewed a facultative certificate that obliged the reinsurer to indemnify the ceding company against "losses or damages … subject to the reinsurance limits" and provided also that the reinsurer was "liable for its proportion of allocated loss expenses incurred by" the ceding company. The 2nd Circuit distinguished its decision in *Bellefonte* primarily on the basis that expense was not expressly made subject to contract limits (which was the case in *Bellefonte*, as well) and remanded the case for consideration of extrinsic evidence as to contractual intent. It is possible, too, that the 2nd Circuit may certify the issue to the New York Court of Appeals, the state's highest court, but that court has previously followed *Bellefonte*. As of mid-July, the case remained pending before the 2nd Circuit and was awaiting decision.

Making Sense of Expense

As the foregoing suggests, consideration of the controlling law and the specific reinsurance contract language is important. As with many issues, the judicial forum in which the dispute is pending also can be outcome determinative. Another important dimension is the mode of dispute resolution selected by the parties. Many reinsurance contracts, including facultative certificates, require that disputes be resolved by arbitration. Arbitration clauses often require arbitration before experienced members of the insurance and reinsurance industry and, particularly where an "honorable engagement" provision is included in the reinsurance contract, arbitration clauses generally allow the arbitrators to abstain from following strict rules of law. Accordingly, business considerations, the parties' course of dealings and industry custom and practice may sway the arbitration panel or even supersede rules of law. Skillful litigators, it should be added, sometimes are able to convince a court to consider some of these factors where the court finds the contract to be ambiguous. Although reinsurance arbitrations generally are confidential, anecdotally it can be said that arbitration results on the issue of the Bellefonte Cap have been mixed.

Finally, although no universal rule has emerged on treatment of expenses under facultative certificates, some practical pointers are worth noting:

Contract language: Although not all decisions can be reconciled by differences in contract wording, contract language still matters in making sense of court decisions and in advocating for a particular determination. Ceding companies and reinsurers alike are well-served by expressly addressing the treatment of expenses at the time of negotiation and by making sure the language comports with the desired result. Careful selection of the manner of resolution (i.e., arbitration or litigation), the forum if litigation is preferred, and choice of law are important considerations at the time of reinsurance placement.

Ceding company arguments: Ceding companies seem to do best by pointing out contract language to distinguish *Bellefonte*, by showing that the industry custom and practice supports payment of expenses in addition to limits, and by advancing arguments regarding concurrency between the facultative certificate and the insurance policy being reinsured. Although arguments often are advanced regarding "follow the fortunes" or "follow the settlements" and distinguishing property from liability business, those arguments have not gained particular traction with respect to this issue.

Reinsurer arguments: Reinsurers generally have fared well by focusing on the similarity of their contract language to that in *Bellefonte*, focusing on adhering to precedent, and arguing that the certificate pricing was based upon stated limits capping total liability. Arguments regarding unfairness about "increasing" the limits often are used to counter the "concurrence" arguments made by ceding companies. BR