THE FINANCIAL CRISIS: INSURANCE AND REINSURANCE LEGAL DEVELOPMENTS

Notification - Disclosure - Aggregation/One Event - Fraud - Follow the Fortunes

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A. Disclosure

(i-iii) Contracts of insurance are treated as contracts requiring the utmost good faith. Under this duty, the insured has a duty to disclose all facts material to the risk. The insured's disclosure duties vary depending on state statute and the type of policy at issue.[1] The generally accepted test for materiality of information is whether a reasonably careful and intelligent underwriter would have regarded the non-disclosed fact as something that substantially increases the risk or something that changes the character and extent of the risk.[2] Materiality is determined from when the contract was entered. It is not measured by the ultimate loss.[3]

In general, when underwriting a risk, an insurer may rely on the representations of the insured, and the insurer has no duty to investigate those representations.[4] On the other hand, when the insured risk is subject to the insured's own judgment (the value of a financial instrument), the insurer issues coverage at its own risk. Courts have held that where a disclosure in an application is a matter of opinion, rather than actual fact, an insurer must typically prove fraud to rescind the policy as opposed to a mere failure to disclose.[5] Under this standard, if a risk requires a certain level of valuation by the insured, then so long as the insured disclosed that value in good faith, the insurer most likely could not rescind the policy, even if the valuation turns out to be materially erroneous.

Additionally, recent case law appears to be trending towards placing greater responsibility on specialty insurers in the investigation of a risk before it may rescind a policy based on a lack of disclosure.[6] In *J.P. Morgan Chase & Co. v. Twin City Fire Ins. Co.*, a 2006 coverage case, the courts were still dealing with the last big U.S. financial scandal, the fall of Enron and World Com. The Enron Scandal broke just prior to Chase Bank renewing its coverage. During the renewal process, Chase issued notice to its insurers that it had $900 million in secured and unsecured exposure to the Enron scandal and that it expected shareholder and securities suits. After the policies were renewed, Chase settled these investor suits for $2 billion. Immediately after, Chase then faced exposure from the World Com scandal. The carrier refused to indemnify Chase for the World Com losses because it argued that the original notice by Chase regarding the

Enron scandal misrepresented Chase's exposure to these types of securities claims. The carriers argued that Chase, in its first notification/disclosure, claimed that it was only exposed to $900 million in losses, but then it paid $2 billion to settle the claims. The carriers wanted to rescind the renewed policies as they applied to the WorldCom claims. The court refused to let the carriers rescind their policies. In its discussion regarding rescission, the court found that the insurers, after receiving the initial notice of Chase's possible exposure to the Enron scandal, should have investigated further and elicited more information from Chase regarding its exposure before it renewed the policies. The court ultimately denied the rescission on the grounds of waiver. Thus, while the court denied the rescission based on other grounds, it appears that courts may be willing to impose more investigatory obligations on insurers when it comes to underwriting certain risks.

(iv) Under U.S. law, a broker only has a fiduciary duty to the insured. The broker generally owes no duty to the carrier. A recent U.K. case expanded the duties a broker owes to the insured in regard to disclosure. These expanded duties also arguably create a de facto duty of disclosure to the insurer. In the case, *Nicholas G Jones v (1) Environcom Limited; (2) Environcom England Limited and MS Plc*, a U.K. court ruled that a broker had a duty to the insured to ensure that it understood what information was material to the insurance contract and needed to be disclosed to the insurer. The court went so far as to require that the broker work to elicit certain facts from the insured that it knew an insurer may find material to the insurance contract. It was not sufficient that that broker merely pointed out the disclosure requirements of the policy. While this ruling was specifically meant to protect insureds, it also protects the insurer as it should help carriers better underwrite complex risks since knowledged brokers will be eliciting the necessary information. [7] It does not appear that any U.S. court has imposed a similar duty on brokers.

(v) The primary remedy for non-disclosure or a misrepresentation is rescission. Courts, however, and as explained above, may be growing more reluctant to rescind policies, especially those types of specialty policies affected most by the Financial Crisis. As insurance companies become more specialized within certain markets, such as monoline carriers or specialized E&O carriers, courts may start to require that such insurers be more proactive in evaluating their risks before they will allow those insurers to rescind a policy based on an alleged misrepresentation.[8] Consequently, as insurers try to rescind policies to avoid massive losses due to the Financial Crisis, they may be opening a gateway for courts to impose new duties on insurers to investigate a risk before they underwrite it.

II. Notification

(vi) There is no uniform standard amongst the states as to whether a notification clause functions as a condition precedent to coverage under a reinsurance treaty. Courts from states such as North Carolina, New York and Illinois hold that a breach of the clause is a bar to recovery regardless of whether the reinsurance treaty explicitly designates the notice condition as

being a "condition precedent."[9] The rationale underlying the rule in these states is that the notice clause is included to afford a reinsurer the opportunity to participate in the defense of an underlying claim as it may ultimately be liable on the claim. As the reinsurer maintains the right to associate in the defense, the clause should function as a condition precedent to coverage, regardless of whether the reinsurer actually invokes its right to associate in the defense.

Conversely, some states require clear and explicit wording in order for the clause to qualify as a condition precedent. California courts have ruled that a clause generally requiring immediate notice upon knowledge of any occurrence likely to give rise to a claim does not function as a condition precedent as there was not a sufficiently clear expression of that intent in the clause itself.[10] Similarly, Colorado courts have found that where a policy or treaty includes other provisions that are specifically designated as "conditions precedent" and the notice clause does not contain that same designation, the court will not construe the notice clause as a condition precedent.[11]

Ultimately, it appears that courts take a results oriented approach – if they want to recognize the provision as a condition precedent, they will simply reference the public policy rationale underlying a reinsurer's right to associate; if they want limit the precedential nature of the condition, they will strictly construe the policy language. The best way to avoid this distinction is to simply include language identifying the language requirement as being a condition precedent.

As an aside, under English law, determining whether the Notice clause qualifies as a condition precedent depends upon whether the actual language of the treaty places a conditional link between the notice requirement and the reinsurer's obligation to pay the claim.[12]

(vii) Generally speaking, the reinsured is under no obligation to notify the reinsurer with regard to the claim, and the reinsurers are not entitled to interfere with the settlement process or with the reinsured's defense of the claim, unless the policy contains a clause requiring notice. Even amongst policies that do include notice conditions, there is no standard language that comprises the notice requirement. Some forms require "immediate" notice of circumstances that "may" or "are likely" to give rise to a claim, some specify the period of time from the reinsured's notice of loss, and some simply require notice "as soon as reasonably practicable." In the United States, clauses requiring "prompt notice," notice "as soon as practicable," and "immediate notice" are interpreted as requiring notice within a "reasonable period of time."[13]

(viii) As discussed above, the application of the notice clause looks to whether the reinsured provided notice within a reasonable period of time. The reasonableness is an objective test and looks to when notice was provided to the reinsurer compared to when a prudent reinsured would believe its policy will be involved in the underlying claim.[14]

In the context of the global financial crisis, reinsureds should be aware of not only the type of claims that are evolving, but also the volume of claimants that are participating in these suits. For instance, where the reinsured receives notice of a solitary sub-prime mortgage claim concerning failure to comply with the Truth-In-Lending Act requirements, an ordinary prudent reinsured should be aware that such claims are not isolated suits, but often involve hundreds or thousands of claimants that may bring similar causes of action against an insured. Thus, what the "reasonable" reinsured should report to its reinsurer from an objective standpoint has changed – the reinsured must be consciously aware that suits concerning the financial crisis which are relatively small at their inception can often snowball into much larger claims.

(ix) With respect to the form the notice should take, the reinsurance treaty should first be consulted. Oftentimes these treaties describe the proper means of notifying a reinsurer for various types of claims (*i.e.* the information that needs to be provided to the reinsurer). Otherwise, the notice provided to the reinsured should provide all available information concerning the claim, and should be in writing. This is to guard against a reinsurer subsequently arguing that the reinsured failed to comply with the notice condition.

Of course, there will be a difference in notice requirements depending upon the type of reinsurance. In treaty reinsurance, the ceding company is contractually bond to cede and the reinsurer bound to assume a specified category of risks. The treaty reinsurer does not separately evaluate each risk assumed. In facultative reinsurance, the ceding company cedes and the reinsurer assumes all or part of the risk assumed by a particular specified policy. The reinsurance agreement is normally purchased by ceding companies for individual risks not covered by their other reinsurance treaties. Ceding companies have argued that notification requirements need only be in the form of periodic bordereaux for treaty insurance.

III. Fraud

(x) The definition of "fraud" varies state-to-state, and the definition can often change depending on the cause of action in which it is claimed. In most circumstances, however, states have adopted definitions through common law or statutory law that track the definitions found in Black's Law Dictionary: "[1] a knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment; [2] A misrepresentation made recklessly without belief in its truth to induce another to act; [3] A tort arising from a knowing misrepresentation made to induce another to act to his or her detriment."[15]

(xi) An overwhelming majority of financial crisis-related claims allege some type of fraud, and also include a corresponding claim of negligence. The inclusion of fraud claims are likely included in most instances to plead around the business judgment rule – which creates a presumption that directors and officers of a corporation make decisions for the best interests of the corporation. Plaintiffs allege fraudulent conduct in an attempt to prevent directors, officers and other upper-echelon employees from arguing that it should be presumed that their conduct

was in the corporation's best interests, and instead involved some type of self-dealing. Plaintiffs include claims of fraud for the purpose of showing that the directors and officers were motivated to further their own interests over those of the corporations and stockholders.

(xii) While both D&O and E&O policies will likely be implicated as a result of these financial crisis-related claims, E&O insurers will likely see the greater number of claims being tendered. Most financial professionals maintain some type of E&O policies, and those insureds are seeing a significant increase of claims in light of the economic downturn.

IV. Aggregation/One Event

(xiii) Aggregation clauses allow a reinsurer to treat several related claims as a single claim. These aggregation clauses vary in that they allow a reinsurer to treat several claims that arise out of a single event, occurrence, or cause or series of related events, occurrences, or causes, as one claim. Courts interpret the terms "event," "occurrence," and "cause" differently. Additionally, reinsurance provisions differ in that some have language that allows the aggregation of claims arising out of a single, event, occurrence, or cause; whereas other reinsurance policies allow for the aggregation of claims that arise out of a single or "series of related events, occurrences, or causes." [16]

The terms "event" and "occurrence" are generally used more in English reinsurance agreements.[1] U.K. courts find that if the aggregation clause contains the term "event" then to aggregate the claims, the claims must be unified in cause, locality, and time. Further, the "event" that links the claims must have caused the claims.[17] U.K. courts generally hold that the terms "event" and "occurrence" are to be treated similarly, such that to be aggregated, the "occurrences" must be related spatially and temporally. [18] The term "cause" is more common in U.S. aggregation provisions.[19] U.S. courts interpret the term "cause" more broadly than "event" or "occurrence," in that claims arising from the same "cause" may be aggregated even if they lack spatial or temporal relationships.

(xiv) Perhaps the most obvious of the Financial Crisis claims that will raise aggregation issues are the sub-prime mortgage claims. These claims involve individual sales of homes all over the country and all over the span of several years, and which will result in huge losses for mortgage companies. Whether reinsurers will be allowed to aggregate these claims clearly depends on the language of their aggregation provision. As explained above, the terms "event" and "occurrence" are interpreted more narrowly then "cause." Provisions with the terms "event" and "occurrence" generally require that the claims be related in time, locality, and cause. It is unclear whether courts will find that claims arising out of a subprime mortgage issued in Florida in 2005 and a subprime mortgage issued in 2007 in New York will be sufficiently related in time, space, and cause that they may be aggregated. It is even unclear whether courts will find that

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subprime mortgage claims are sufficiently related to be aggregated under "cause" aggregation provision. Many of these are arising out of different violations of the Truth In Lending Act that occurred at each of the closings. These closings were generally all performed by different closing agents who allegedly made varying mistakes in the closing that led to the litigation. Given these multitude of factors, some courts may be unwilling to aggregate these claims, even under a "cause" aggregation provision.

V. Follow The Fortunes/Settlements

(xv-xvi) We were unable to locate any U.S. case law discussing whether a reinsured settlement was binding on a reinsurer in the absences of a follow the settlements clause. From our research, it appears that a follow the settlements clause, in some form, is standard in most reinsurance policies issued in the U.S.[20] Further, it appears that U.S. courts are even willing to imply a follow the fortunes clause within any reinsurance policy.[21] Therefore, under U.S. law, absent fraud, collusion, or bad faith by the reinsured, it is allowed to recover for any settlement from its reinsured. [22] That being said, if there is no follow the settlements clause, then U.K. courts hold that a reinsured must prove that it was liable under its insurance contract before it may recover from the reinsurer. Courts have made this extremely difficult to do when the reinsured settles the claim without an adjudication. It appears that if a reinsured settles without a follow the settlements clause, it must produce evidence that its decision to settle the claim was based on the fact that the claim was within the coverage of the policy. It is unclear what the extent of the evidence that is needed by the reinsured to prove this. In other words, it appears that a full blown coverage suit on the merits of the underlying case could be required for the reinsured to recover a settlement from the reinsured in the absence of a follow the settlements clause. [23]

VI. *Lexington Insurance Company v Wasa International Insurance Company Limited* [2009] UKHL 40.

The recent case of *Lexington v. Wasa* arguably impacts how future courts will interpret reinsurance policies when the insurance policy and the reinsurance policy are governed by the laws of two different jurisdictions. This decision by the House of Lords essentially modifies the long standing application of the "back to back doctrine" between the insurance policy and the re-insurance policy. In *Lexington v. Wasa*, Lexington had insured Alcoa from 1977 to 1981 and Wasa issued a reinsurance policy to Lexington for that same period. The U.S. government required that Alcoa conduct an environmental clean-up at a number of sites for damage that occurred over 50 years. Coverage litigation between Alcoa and several insurers ensued in Washington State. There was no choice of law provision in the insurance contracts. The Supreme Court of Washington found that Pennsylvania law governed all the insurance contracts. Among other things, the Washington Supreme Court found that under Pennsylvania law, each

insurer was jointly and severally liable for all environmental damages over the 50 years and not just the damage the occurred during its policy periods. This greatly increased Lexington's liability. Lexington settled with Alcoa and sought reinsurance from Wasa.

Wasa is a U.K. company. The Wasa reinsurance contract also did not have a choice of law provision. Wasa filed suit on the reinsurance policy in the U.K. It was determined that U.K. law governed the policy. Under U.K. law, an insurer may only be liable for the portion of damages that occurred during its policy period. Thus, there was a conflict between English law and Pennsylvania law. Lexington argued that the conflict did not matter because the reinsurance policy contained a "follow the settlements" clause, and therefore the reinsurance policy must be interpreted the same as the insurance policy. The House of Lords found that just because the reinsurance policy contained a "follow the settlements" clause did not mean that it had to interpret the policy the same as the U.S. court. Instead, absent a provision stating U.S. law applied, the House of Lords ruled that a U.K. court could interpret the reinsurance policy according to English law, even if that would lead to a different result than how the insurance policy was interpreted. Consequently, the decision in *Lexington v. Wasa* shows that U.K. courts will allow different law to govern the reinsurance contract even though the decision may run contra to the "back to back" doctrine.

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[1] *See* 44 Am. Jur. 2d Ins. § 1009; *Golden Rule Ins Co. v. Schwartz*, 203 Ill.2d 456, 464 (2003).

[2] *Parks v. Federal Crop Ins. Corp.*, 416 F.2d 833 (7th Cir. 1969).

[3] *Wesley v. Union Nat. Life*, 919 F. Supp. 232 (S.D. Miss. 1995).

[4] *Lowry v. State Farm Mut. Auto. Ins. Co.*, 421 N.W. 2d 775 (1988).

[5] *Russell v. Royal Maccabees Life Ins. Co.*, 947 P.2d 443 (Ariz. App. 1998).

[6] *J.P. Morgan Chase & Co. v. Twin City Fire Ins. Co.*, Sup. Ct. N.Y. 601904/06.

[7] Edwards Angell Palmer & Dodge LLP, *UK: High Court Provides Guidance on the Role of the Insurance Broker in Relation to the Duty to Disclose to Insurers*, available at h
http://www.martindale.com/insurance-law/article_Edwards-Angell-Palmer-Dodge-LLP_1002318.htm

[8] *See UST Private Equity Investors Fund, Inc. v. Saloman Smith Barney*, 288 A.D.2d 87 (App. Div. 2001)(finding that sophisticated investors cannot reasonably rely on representations of brokers when investor could have easily verified information on its own); *Insurance Aftershocks of the Financial Crisis: New Coverage Issues In a Brave New World*, David F. Klein, Barry S. Levin, Lisa M. Cirando, and Alexandra L. Brandon of Orrick, Herrington & Sutcliffe, LLP.

[9] *Fortress Re, Inc. v. Jefferson Ins. Co. of N.Y.*, 628 F.2d 860 (4th Cir. 1980); *Keehn v. Excess Ins. Co. of America*, 129 F.2d 503 (7th Cir. 1942); *Travelers Ins. Co. v. Buffalo Reinsurance Co.*, 735 F. Supp. 492 (S.D.N.Y. 1990).

[10] *Nat'l American Ins. Co. of Cal. V. Certain Underwriters at Lloyd's London*, 93 F.3d 529 (9th Cir. 1996).

[11] *Security Mut. Cas. Co. v. Century Cas. Co.*, 531 F.2d 974 (Colo. 1976).

[12] *Friends Provident Life & Pensions Ltd. v. Sirius Int'l Ins. Corp.*, 2 Lloyd's Rep. 517 (2005).

[13] *See Christiania Gen. Ins. Corp. of N.Y. v. Great American Ins. Co.*, 979 F.2d 268 (2nd Cir. 1992); *Travelers Ins. Co. v. Buffalo Reinsurance Co.*, 735 F.Supp. 492 (S.D.N.Y. 1990); *Zenith Ins. Co. v. Employers Ins. of Wausau*, 141 F.3d 300 (7t Cir. 1998); *Centaur Ins. Co. v. Safety Nat'l Cas. Corp.*, 1993 WL 434056 (N.D. Ill. 1993).

[14] *Id.*

[15] *See e.g., U.S. v. Argumendo-Perez*, 326 Fed. Appx. 293 (5th Cir. 2009); *Day v. Staples, Inc.*, 555 F.3d 42 (1st Cir. 2009); *Info-Hold, Inc. v. Sound Merch., Inc.*, 538 F.3d 448 (6th Cir. 2008); *Henry v. Lehman Commer. Paper, Inc.*, 471 F.3d 977 (9th Cir. 2006) (citing California statutory law); *Miller v. Image Data, LLC*, 91 Fed. Appx. 122 (10th Cir. 2004).

[16] Colin Croly, *The Reinsurance Implications of the Enron Collapse*, at 10, available at www. thefederation.org/documents/Colin-F02.htm.

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] Peter Chaffetz and Cecilia Moss, *Follow Fortunes and Allocation: An Update,* Journal of Reinsurance 55-70 (Vol. 16, No.2) Spring 2009.

[21] *Id.* n.4 (citing *See, e.g. Int'l Surplus Lines Ins. Co. v. Certain Underwriters & Underwriting Syndicates at Lloyd's of London*, 868 F. Supp. 917, 920 (S.D. Ohio 1994)

[22] *Id.* at 60.

[23] ***Commercial Union Assurance Co. v. NRG Victory Reinsurance, Ltd.*** **[1998] 2 Lloyd's Rep. 600**