Coloring Outside the Lines:

The Limits of Extra-Contractual Obligations in Life and Property/Casualty Reinsurance

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Adams and Reese LLP

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Introductions and Overview

- Overview of Extra-Contractual (ECO) claim exposures and common wordings in Property/Casualty Reinsurance Contracts
- Panel Discussion: Common Property-Casualty ECO Issues
- Review of ECO in Life Reinsurance
- Panel Discussion: Common Life ECO Issues
- Audience Participation regarding Property/Casualty Claim Scenario

ECO Claim Exposures – Property/Casualty

- "Bad faith" generally refers to tort damages - *i.e.* cedent's liability for "bad acts" independent of coverage afforded under the insurance policy
- Common law causes of action

  -implied duty of good faith and fair dealing

  -intentional misrepresentation

  -failure to settle within limits
- Statutory causes of action*, for example, Unfair Claims Practices Acts in various states.*
- Can cover both negligent and intentional conduct
- Can include compensatory, statutory and punitive damages (in states that allow indemnification of punitive damages)

The ECO Clause, by its terms …

- Provides reinsurance coverage for payments made by a cedent that do not arise out of the original property/casualty policy.
- Traditionally does not cover 100% of ECO loss, but requires risk-sharing by the cedent.
- May specify that total liability shall not exceed applicable limit of liability under Retention and Limit.
- ECO is deemed incurred on the date of the original loss occurrence – not a separate or distinct loss.
- Excludes outright fraud on the part of a cedent' s corporate management.

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Compare to XPL Clause – Property/Casualty

- Relates to contract damages - *i.e.* verdict or settlement for insured's covered actions.
- Provides for reinsurance coverage in the event of payments owed by the original policy holder that exceed the original policy limits, *but are of the kind and nature of the risk insured* (i.e. BUT FOR THE QUANTUM, would be covered by the policy).
- Typically allows 100% reinsurance recovery; encourages cedents to act with appropriately aggressive claim handling techniques.

Variations and Enhancements – Property/Casualty Context

- Where ECO coverage is found in a contract
- ECO/XPL – Definitions
- Within limits or in addition to limits
- Counsel/Counsel and Concurrence
- When is ECO payable (upon judgment or settlement)
- Treatment of LAE
- E&O/Warranty
- "Sole Judge" Provision

“Inside the Lines”

- Failure to settle a claim within policy limits
- Denial of claim based on inadequate investigation or without reasonable basis
- Failure to tender a defense (additional insured)
- Failing to disclose the insured's rights or failing to timely settle a claim
- Placing extra-contractual limitations on coverage
- Bad faith in wasting or eroding policy limit situations
- Claim handler or adjuster misrepresentation or fraud

"Outside the Lines"
(or Gray Areas)

- Ex gratia payments
- Payment of benefits for which coverage is doubtful to avoid run-away litigation costs
- Payment of punitive damages award in a jurisdiction where indemnification is prohibited by law
- Payment of claimants' attorneys fees where no legal obligation for fee shifting exists
- Payment of claim subject to statute of limitations or statute of repose
- Exclusion voided based on violation of state filing or licensing laws
- Negligence/misrepresentation in connection with marketing, underwriting, renewal or termination of a policy

Assuming the exposure is subject to E&O coverage in addition to the ECO/XPL coverage in the reinsurance contracts and assuming the contracts are all silent on this issue, ***which pays first***?

- CEDENT: E&O coverage does not inure to benefit of the reinsurer. The cedent purchased (and paid for) both coverages and should be able to choose which applies first. Alternatively, the claim should be prorated but in any event neither can avoid coverage because the other exists.

- REINSURER: Industry practice is the reinsurer should pay after the insurance carrier, as primary coverage should apply first. Alternatively, if the coverages are concurrent, the reinsurance is duplicate coverage and does not apply.

Would outcome be different with these provisions in place?

- Inuring Clause:

  Recoveries, whether collectible or not, including any retentions and/or deductibles, from any form of insurance which protect the Reassured against any loss or liability covered under this Article shall be deducted first from the total amount of any extra contractual obligation in determining the amount of such extra contractual obligation. [BRMA 2001]

  E. Recoveries or collectibles from any other form of insurance or reinsurance which protect the Reassured against Extra Contractual Obligations, shall inure to the benefit of the Reinsurers and shall be deducted from the total amount of Extra Contractual Obligations for purposes of determining the Net Loss hereunder.

- Warranty Clause:

  <u>WARRANTY</u>

  8. It is warranted that the Reassured shall purchase E&O coverage for $5,000,000 excess $750,000 which shall inure to the benefit of this Contract.

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If reinsurance covers ECO expense in addition to limits , is warranty satisfied by E&O coverage written on defense within limits basis?

- CEDENT: Defense within limits E&O coverage is the most common coverage available and satisfies the warranty (assuming warranty is silent on this point). Applying full ECO limits as deduction on loss creates windfall to reinsurer where expense is allocated in proportion to share of the net loss.

- REINSURER: Warranty functions as additional retention for ECO loss and reinsurance was priced on that basis. Reinsurer is entitled to have full E&O limits offset ECO loss.

Assuming the claim is prohibited from being covered by state law (i.e. punitive damages) what is the impact on the reinsurance coverage?

- CEDENT: The state prohibitions apply to insurance, not reinsurance, and the reinsurance does not provide exceptions for when these statutes apply. The cedent paid for coverage regardless of where the claim arises. Further ECO coverage is meant to apply to claims not covered under the underlying policies.

- REINSURER: A reinsurer cannot reinsure that which cannot be insured. Further, the reinsurance coverage for ECO is effectively direct coverage in that it covers losses not covered by the underlying insurance.

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Indemnification Prohibited by Law

<u>Clause 1</u>

In no event shall coverage be provided to the extent not permitted under law. [BRMA]

<u>Clause 2</u>

If any provision of this Article is rendered illegal or unenforceable by the laws, including controlling case law, and regulations of any jurisdiction, such provision will be considered void in such jurisdiction, but this will not affect the legality or enforceability of such provision in any other jurisdiction.

<u>Clause 3</u>

"… in determining whether coverage is permitted, the parties agree to apply the law of the jurisdiction that provides the broadest coverage."

Does a cedent owe a duty to allocate a lump sum settlement where exposure to bad faith, punitive damages, or other extra-contractual liability exists?

- CEDENT: If cedent assigned no value to ECO claim at time of settlement and settlement can be justified under reasonable interpretation of coverage under its policy, the cedent need not allocate to other exposures.

- REINSURER: If there was a factual predicate for ECO and settlement provided release of ECO claims, then some portion of settlement must be allocated to ECO and failure to do so is not reasonable.

Moving On In Life

- **As in property/casualty reinsurance contracts, life reinsurance treaties almost always contain ECO clauses**
  - common in both automatic and facultative treaties
  - common in both proportional (coinsurance) and non-proportional (Yearly Renewable Term) covers

Moving On In Life

- Key Similarities
  - **ECO = compensatory or punitive damages (and statutory penalties) awarded against the cedent itself, for tortious acts or omissions in the claim handling process**
    - Date of ECO = date of original loss
    - Fraudulent or criminal activities of corporate officer or Board member excluded
    - “Other insurance” inures to benefit of treaty
    - “Escape hatch” clause states indemnification for ECO takes place only to extent allowed by jurisdiction

    (LH1 and LH2)

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Moving On In Life

- Key Differences
  - **Market Conduct (agent misrep) not generally covered**
  - **Unlike casualty reinsurance contracts, life reinsurance treaties indemnify cedents for first party insurance coverage**
    - life insurance policies provide pay-outs upon a specified individual's death
    - typically, attacks on claim declinations are mounted by third party beneficiaries (widows and orphans)

Moving On In Life

- Key Differences
  - **No duty to indemnify an original insured for verdict/settlement, so XPL or "excess of policy limits" exposures simply don't exist**
  - **Many life reinsurance ECO clauses involve "counsel and concur" – a delicate dance whereby the reinsurer may review the proposed claim action and decline to participate in ECO exposure, once notified by the cedent (LH1)**

Moving On In Life

- How Life Cedents Can Avoid ECO Exposures
  - Don’t take on “minor” instances of misrepresentation (smoking, dread disease more than 10 years ago) in face of horrific claim circumstances (25-year-old father of two dies in fiery crash) and small face amounts of life policies
  - Assiduously observe “contestability” periods
  - Maintain automated processes for promptly notifying beneficiaries of life coverage and paying proceeds
  - Lapsed policies and policy reinstatements - improper or not

Moving On In Life

- <u>Key News Headlines</u>
  - **Life Cedents have negotiated settlements with several states for asymmetric use of the Social Security death master file**
    - Checking that annuitants have died, while not checking for life insurance policy holders' deaths
    - In first case, benefits would cease, in second case benefits would be paid
  - **Are these global settlements allocable and recoverable on a treaty-by-treaty basis?**

    (Susan = cedent, Steve = reinsurer)

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Moving On In Life

- <u>Key News Headlines</u>
  - **Cedents are engaged in fights with policyholders about "hidden" costs of insurance embedded in variable life insurance products**
    - costs of insurance = mortality and expense charges
    - issues about escalating nature of charges without disclosure to policyholders
  - **Are verdicts or settlements attributable to these issues allocable and recoverable on a treaty-by-treaty basis?**

    (Steve = cedent, Susan = reinsurer)

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Moving On In Life

- **Given a life insurance policyholder with two policies issued by the same cedent, how is ECO loss allocated if one policy is reinsured by a proportional (coinsurance) treaty and the other policy is reinsured by a non-proportional (Yearly Renewable Term) treaty?**
  - assume same cedent's actions and omissions impact both policies (Susan = proportional, Steve = non-proportional)
- **What is the tension that a life cedent and reinsurer experience when negotiating ECO clauses in proportional and non proportional treaties?**
  - how does this issue flow into the arbitral process?

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Moving On In Life

- **How should the responsible life reinsurance claims/underwriting professional gauge whether ECO activity attributable to a single life cedent is just too much?**
  - if there are several treaties with this cedent, how best can the life reinsurance professionals evaluate the overall exposure?
  - when, if ever, should the reinsurer discontinue the relationship altogether?

Time to hear from the Audience

- **Casualty bad faith/failure to settle claim scenario … with a few twists:**
  - ✓ Company issued both primary and umbrella policies.
  - ✓ Umbrella ECO reinsured separately from primary ECO
  - ✓ Bad faith allegations include improper claim denial, handling of defense and trial, and failure to settle within limits
  - ✓ XPL liability hinges on coverage for additional insured
  - ✓ Significant prejudgment interest
  - ✓ Cedent has E&O coverage for ECO claims

Questions to Audience

- Can reinsured allocate entire ECO settlement payment to XOL/Clash reinsurance covering primary business, where umbrella QS reinsurance was exhausted by payment of covered loss?
- Can reinsured allocate subsequent $5 million E&O recovery entirely to ECO LAE?
- Is prejudgment interest treated as loss or expense?

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