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REINSURANCE: THE SILENT REGULATOR?

Aviva Abramovsky*

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This article suggests that a discussion on insurance regulation should include a consideration of the effect that reinsurance may have on the behavior of insurers. The traditional types of reinsurance are reviewed, and the ability of private reinsurance contracts to produce insurer action is considered. If reinsurance is not included in a holistic examination of the field, its realities have the capacity to misdirect insurance regulatory assumptions. Moreover, reinsurance works as a source of independent and often unexamined contractual influence on insurer activity, and as a potential source of interference with regulatory proposals. Even though reinsurance is initiated by private contract, those contracts have the potential for regulatory effect sufficient to provide a positive answer to this Essay’s main query: may reinsurance correctly be termed a “silent regulator”?

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"The first principle of regulation is: Lawyers and politicians write rules; and markets develop ways to circumvent these rules without violating them."1

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1 Allan H. Meltzer, Regulatory Overkill, WALL ST. J., Mar. 27, 2008 at A14.
I. INTRODUCTION

When evaluating the efficacy of insurance regulation, the nature and availability of reinsurance is not often considered. Yet, as "the insurance of insurance companies," reinsurance should not be so quickly dismissed as irrelevant in the regulatory discussion. Just as insurance is often viewed as having a regulatory effect on insured industries, so too should reinsurance be considered as having a regulatory effect on its reinsureds.

Initially, a brief discussion of the concept of regulation is necessary. The term "regulation" commonly evokes thoughts of governmental action and visions of the regulatory state. For good or ill, thoughts of regulation are usually linked with thoughts of state power. Yet such a restrictive vision of regulation is simplistic and ignores the capacity of private institutions to regulate the activities of large swaths of social actors. This ability has led to the development of a fascinating body of literature which examines the myriad ways private or quasi-private insurance can regulate private behavior. With the concept of power not limited to overt government action alone, insurance takes its place among regulators of social behaviors with surprising force and scope. Indeed, it has been stated that "looking at twentieth century governance, it is tempting to see insurance as the sleeping giant of power."

Identifying insurance as a private regulator stems from the idea that insurance works as a mechanism to set social standards. Insurance is an

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2 This is not overly surprising since, as one commentator noted, "development of reinsurance in the United States has, for much of its history, gone largely unrecorded." See William Hoffman, Facultative Reinsurance Contract Formation, Documentation, and Integration, 38 TORT TRIAL & INS. PRAC. L.J. 763, 777 (2002-2003).


4 See Gary Marchitello, Ignore Reinsurance at Your Peril, RISK MGMT. MAG., Dec. 2007, at 46 ("Discounting the importance of the vital role of reinsurance in risk spreading and how the pricing, stability and capacity of reinsurance can influence the viability of one's own direct insurance purchases can be a critical and potentially costly mismanagement.").

acknowledged gatekeeper of many economic activities, from buying a home to driving a car to executing a complex financial transaction. Some of this regulatory effect results from a direct delegation of state power by mandating the purchase of insurance as a prerequisite to such things as operating a car or entering a certain business, much, however, does not. When insurance is purchased without governmental compulsion, the nature of the obligations acquired alongside the indemnity function of insurance can be viewed as a form of “private legislation” within the regime of traditional notions of liberal governance.6

The corollary of the idea of insurance as private regulator of policyholders is to consider the concept of reinsurance as a source of private regulation of reinsured insurance companies. In effect, if insurance is a “sleeping giant of power”, how much more so is the power of reinsurers to affect the behavior and choices of insurers themselves? Through this vantage point, the reinsurance relationship begins to emerge as a subject requiring careful review and analysis in the regulatory context. Though purely private in origin7 and function,8 reinsurance of insurance

6 Id. at 13.

7 See 3 NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE: SEPARATE LINES OF INSURANCE, § 40.01, at 6 (2007) (“The reinsurance relationship is evidenced by a written contract reflecting the negotiated terms. Although reinsurance contracts between different cedents and reinsurers can include clauses with similar purposes, the wording of particular provisions varies significantly, depending on the parties’ specific needs, customs and practices.”).

8 See ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW § 142(d), at 1021 (4th ed. 2007) (“In many respects, the relationship between primary insurer and reinsurer tracks that of the original insured and the primary insurer. The primary insurer and reinsurer have a duty to deal with each other in good faith, and the reinsurer will have available to it the defense of misrepresentation, breach of warranty, fraud, or concealment in circumstances where the primary insurer’s acts or neglect give rise to the defense.”). See also STEVEN PLITT, ET AL., 1A COUCH ON INSURANCE § 9:17 (3d ed. 2008) (“Duties of good faith and fair dealing run between the reinsurer and the reinsured much as they do between the initial insured and his or her insurer. This duty originates from the reinsurer’s need to rely upon and not duplicate the reinsured’s efforts in properly evaluating risks and handling claims, reducing costs for both parties to the reinsurance contract. Accordingly, this duty requires the reinsured to disclose to the reinsurer all material facts which may affect the subject risk. The extension of this duty of good faith is the related
policies is common practice of the domestic insurance industry.\(^9\) For reasons described below, the benefits of reinsurance to an insurer are manifold\(^10\) and the likelihood that an insurer will seek reinsurance at some point great.\(^11\) Hence the function of this Essay: to determine whether concept that reinsurers are generally bound by the reinsured’s good faith decision to pay a claim, commonly referred to as the ‘follow the settlements’ doctrine.”).

\(^9\) Though reinsurance agreements may use any language the parties may choose to effectuate their agreements, commonly found reinsurance clauses abound. See BARRY OSTRAGER & THOMAS NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 15.03(b), at 997 (12th ed. 2003) (“Reinsurance treaties may contain ‘follow the fortunes,’ ‘errors and omissions,’ ‘notice,’ ‘arbitration,’ ‘claims cooperation,’ ‘salvage and subrogation,’ ‘allocation of expenses,’ ‘extra contractual obligations,’ ‘punitive damages’ and/or ‘cut through clauses.’ The wording of these clauses in different reinsurance certificates and treaties can also vary substantially.”).

\(^10\) See REINSURANCE ASSOCIATION OF AMERICA, Fundamentals of Property and Casualty Reinsurance 4 (2009) http://www.reinsurance.org/files/public/07FundamentalsandGlossary1.pdf (“Reinsurance provides protection against catastrophic loss in much the same way it helps stabilize an insurer’s loss experience. Insurers use reinsurance to protect against catastrophes in two ways. First, reinsurance protects against catastrophic financial loss resulting from a single event, such as the total fire loss of a large manufacturing plant. Second, reinsurance also protects against the aggregation of many smaller claims resulting from a single event, such as an earthquake or major hurricane, that affects many policyholders simultaneously. While the insurer is able to cover losses individually, the aggregate may be more than the insurer wishes to retain.”).

\(^11\) See Anna Walker, Harnessing the Free Market: Reinsurance Models for FDIC Insurance Pricing, 18 HARV. J. L. & PUB. POL’Y 735, 742-43 (1994-1995) (“Reinsurance is sought by primary insurers for various reasons. From an economic standpoint, reinsurance permits an efficient specialization of skills. In a simplified world, primary insurers are small, local, and specialized; reinsurers, on the other hand, are well capitalized international corporations with highly diversified risk portfolios. Primary insurers, because of their proximity to and knowledge of the insured, have an advantage over reinsurers in soliciting customers, pricing policies, and monitoring insureds for moral hazard. Reinsurers, on the other hand, have advantages in raising capital and diversifying and managing risk, particularly the risk of a catastrophe which might bankrupt a small private insurer. Insurers, therefore, can trade their advantages in pricing and moral hazard monitoring for the greater risk-bearing capacity of the reinsurer. Primary
reinsurance can properly be understood as a little acknowledged and "silent regulator" of the insurance industry.

To that end, Section II of this article will describe what reinsurance is and why insurers seek it. Section III will explore the main purposes of reinsurance. Section IV will review various ways reinsurance has the capacity to influence certain insurance industry behaviors. This will include a review of reinsurance's effects on reinsured's underwriting and claims handling practices, along with a discussion of general consumer protection issues. Section V will offer a conclusion.

Before beginning that discussion, it is important to note that insurance is not, of course, an unregulated industry, though it is the only major financial industry regulated primarily at the state level. State regulators coordinate their efforts through the highly competent National Association of Insurance Commissioners (NAIC). Moreover, these state regulators share identifiable and reasonably identical goals in the performance of their duties. Among these are the promotion of competitive and sound insurance markets and the enforcement of insurance laws to assure consumers of fair treatment and protection from unfair trade practices. Throughout the course of this Essay, therefore, mention will be

insurers also may find reinsurance necessary meeting regulatory restrictions that limit exposure to any individual risk. By retaining only a portion of each insured risk, the insurer is able to insure a greater variety of risks with the same amount of capital, assuming that state regulators permit it to subtract reinsured risk from its reserve requirements.


13 Insurance regulatory interests include the perennial issues of risk containment and default. However, risk of default is not the sole purview of insurance regulation. Included in regulatory efforts are issues of political interest, such as guaranteeing equitable access to insurance, and other redistributive and equitable normative policies. For example, the Connecticut Department of Insurance describes its mission as follows:

The mission of the Connecticut Insurance Department is to serve consumers in a professional and timely manner by providing assistance and information to the public and to policy makers, by regulating the insurance industry in a fair and efficient manner which promotes a competitive and financially sound insurance market for
made of reinsurance’s potential as a source of support or hindrance to insurance regulatory interests. Such review gains added importance with the recognition that, other than as regards some issues of solvency, the reinsurance industry is generally unregulated at all.\(^{14}\)

II. REINSURANCE: WHAT IS IT AND WHY HAVE IT?

At its most reductive, reinsurance is a relatively straightforward financial transaction by which an insurance company is indemnified for all or a portion of some risk by another insurer.\(^{15}\) This risk transfer, just as with common consumer or commercial insurance policies, is effectuated by contract, with the reinsurance agreement mainly subject to ordinary contract rules and doctrine. Some practices of reinsurance contract interpretation are distinct from the practices used in interpreting a more common insurance policy, but at this juncture it is sufficient to recognize that reinsurance is a creature of contract.\(^{16}\)

consumers, and by enforcing the insurance laws to ensure that consumers are treated fairly and are protected from unfair practices.


\(^{14}\) See Reinsurance Association of America, supra note 11, at 13 ("Since reinsurance regulation focuses on solvency, it safeguards the validity of reinsurance policies and, at the same time, maintains flexibility in the business of reinsurance. By focusing on the reinsurer, rather than on the reinsurance contract, primary insurance companies are allowed to purchase reinsurance to suit their particular business needs. Of course, reinsurance contracts are entered into by two or more insurance companies – the reinsurer(s) and the insurer(s). Recognizing that there are always some exceptions to the rule, the two companies are generally expected to be knowledgeable about the insurance business. Therefore, the oversight necessary in primary insurance to protect consumer interests is not essential in the reinsurance business.") (emphasis added).

\(^{15}\) See Jerry, supra note 9, § 140(a), at 1015 ("Reinsurance is essentially a form of insurance for insurance companies.").

\(^{16}\) Plitt, supra note 9, § 9:6. ("Although some rules of construction do not apply to contracts in the reinsurance context, the general rules of contract do apply to reinsurance contracts.").
A. WHAT IS REINSURANCE?

Perhaps the most difficult aspect of the study of reinsurance stems from the particularly opaque and obscure language endemic to the industry. Some discussion of terms is necessary. As reinsurance involves a minimum of two insurance companies, different terms have developed to identify the various parties. The original insurer who acquired the risk or liability is referred to by a variety of designations, including that of direct or initial insurer and sometimes, though less commonly, as the primitive insurer. However designated, once it has entered into an agreement with a new insurer for the purpose of reinsurance, the original insurer is thereafter most commonly referred to as the reinsured. Though that seems clear enough, the original insurer is frequently referred to by another more exotic definition, that of cedent. This designation stems from the idea that the function of reinsurance is for the original insurer to "cede" a certain amount of its business to the reinsurer, hence the term cedent.

17 See JERRY, supra note 9, § 140(a), at 1015 ("The business of reinsurance has developed some special terminology."). See also NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE, supra note 8, § 40.01, at § 40.05 (2007) ("Reinsurance, like many areas of business law, has a language of its own.").

18 See PLITT, supra note 8, § 9:2 ("There are two parties to a reinsurance agreement, but these parties have been bestowed with multiple names which are used interchangeably and are all accurate.").

19 See GRAYDON S. STARING, THE LAW OF REINSURANCE § 1:1, at 3 (Supp. 2008) ("The original insurer, sometimes called the direct, or initial, insurer, and occasionally the primitive insurer, is commonly called the reinsured or, especially in England, the reassured.").

20 See OSTRAGER, supra note 10, § 15.01(c), at 992 (noting a ceding insurer or reinsured is "the insurer that transfers all or a portion of the risk it underwrites to a reinsurer.").

21 See STARING, supra note 20, § 1:1, at 3 ("The reinsured is said to cede business to the reinsurer, or reassurer, and is therefore also referred to as the ceding company or the cedent (or cedant)"). See also NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE, supra note 8, § 40.01 ("The insurance company purchasing reinsurance is called the 'ceding company' (or the 'cedent' (or 'cedant'), 'reinsured' or 'ceding insurer') because it 'cedes' or transfers part of the risk.").
Likewise, a reinsurer may itself seek reinsurance, called retrocessions, in the same forms and for the same purposes as any other insurers.\textsuperscript{23} Hence, the reinsurer of a reinsurer is often called a retrocessionaire.\textsuperscript{24}

As a descriptive matter, reinsurance is inherently a contract of insurance, albeit a secondary one.\textsuperscript{25} Reinsurance is commonly defined as a contract "by which an insurer procures a third person to insure him against loss or liability by reason of such original insurance."\textsuperscript{26} More generally,

\begin{itemize}
  \item \textit{See JERRY, supra note 9, § 140[a], at 1054} ("The act of transferring the risk is called 'ceding,' and the portion of the risk passed to the reinsurer is called the 'cession.'").
  \item \textit{See PLITT, supra note 9, § 9:3} (The retrocessional agreement, like any other reinsurance agreement, is a contract and will be effective according to its terms. These terms need not mirror the specific risks of the reinsurance agreement which it is reinsuring. As can quickly be deduced, with the expansion of the insuring scenario from one to three or more separate agreements, all of which may cover different risks and have different exclusions, the resolution of indemnity responsibility can easily become complex).
  \item The preponderance of French terminology likely arises from the early statutory action by the French Courts in the reinsurance business. For instance, notice of the 1681 Ordonnance de la Marine of Louis XIV provided that:

  \begin{quote}
    "The insurers may reinsure with others the effects they may have insured, and the insured may likewise cause to be insured the premium of insurance, and the solvency of the insurers.
  \end{quote}

  \textit{STARING, supra note 20, § 1:4, at 6} (providing translation of Article XX, Title Sixth of the 1681 Ordonnance).
  \item \textit{PLITT, supra note 9, § 9:1} ("Reinsurance is a contract whereby one insurer transfers or 'cedes' to another insurer all or part of the risk it has assumed under a separate or distinct policy or group of policies in exchange for a portion of the premium . . . While reinsurance technically qualifies as insurance, it is a contract for indemnity rather than liability.'").
  \item \textit{See STARING, supra note 20, § 1:1, at 2} (This definition allows for the inclusion of both an existing policy or contract of reinsurance and assumes that the requirements of the contract are met. A "reinsurance policy" can therefore simply be understood as a "contract for indemnity one insurer makes with another to protect the insurer from risks already assumed." Likewise a treaty looking forward
\end{itemize}
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reinsurance includes all contractual arrangements where one insurance company transfers to another all or some portion of the risk it underwrites to another insurer. Thus, the common refrain that reinsurance is insurance for insurance companies.

One of the hardships in understanding reinsurance is that the term is sometimes used over-broadly and applied to relationships which are best understood as something other than a commonly accepted definition of reinsurance. Reinsurance is best understood as distinct from co-

to reinsure would constitute reinsurance, though such agreement may be better understood as a contract for reinsurance, rather than a contract of reinsurance. In either case, reinsurance policies, reinsurance treaties on specific classes of risk and reinsurance treaties entered into for future acquired risk would all come within the heading of reinsurance); OSTRAGER & NEWMAN, supra note 10, § 15.01, at 990.

27 See Colonial Am. Life Ins. Co. v. Comm'r, 491 U.S. 244 (1989); OSTRAGER & NEWMAN, supra note 10, § 15.01[a], at 990.

28 See Cont'l Cas v. Stronghold Ins. Co., Ltd., et al., 77 F.3d 16, 17, 20 (2d Cir. 1996). In that case, the Second Circuit offered an additional colorful and intuitive explanation of reinsurance adopted in a New York Court of Appeals decision of the late 1930's. See id. at 17. (discussing People ex. rel. Sea Ins. Co. v. Graves, 274 N.Y. 312, 15 (1937)) (The concept of reinsurance “dates back to the time the first bookie, fearful that he could not cover all his bets in the event he were to lose, decided to spread his risk ‘laying-off’ the risk by getting other bookies to share his exposure.”). Though colorful, that assessment is not entirely accurate. The earliest recordings of the use of reinsurance likely predated the iteration of the modern bookie and has been historically identified as predating the 17th century. See STARING, supra note 20, § 1:4, at 5-6 (“The earliest recorded instance is said to have been a policy written on a voyage from Genoa to Sluys and reinsured for the more hazardous portion, from Cardiz to Sluys, the insurer retaining the Mediterranean portion of the risk.”). The New York courts were not altogether mistaken as England likely recognized the relationship between insurance and speculation in the 18th Century and prohibited marine reinsurance by the Marine Act of 1745. Addressing that Parliamentary Act, Lord Mansfield noted that, “The statute doubtless was intended to prevent gambling. I suppose that the mischief was that policies were underwritten at one premium and reassurance affected at another.” In Re Norwich Equitable Fire Assurance Soc’y 57 LT REP. 241, 243 (1887).

29 See JERRY, supra note 9, § 140[a], at 1053 (“Reinsurance should not be confused with the situation where one insured takes out two or more policies covering the same risk with two or more insurers. Also, reinsurance should not be
insurance, the proper term for the relationship which forms when separate insurers, either jointly or severally, assume direct shares of a given risk; in such cases where all the insurers have a direct relationship with the insured, the relationship is not within the traditional understanding of reinsurance. Likewise, reinsurance should be distinguished from banking even though it may assist in the reinsured’s financing and allow for insurance loss amortization.

In a true reinsurance contract, the risk indemnified is the risk that the insurer will have to pay on the underlying insured risk. Reinsurance is an aspect of insurance and, to the extent that it is regulated at all, is regulated under the rubric of insurance. By entering into a contract to reinsurance, the reinsurer agrees to indemnify the ceding insurer for any liability incurred by the insurer that is covered by the reinsurance

confused with the situation where the insured cancels one policy and substitutes another for it . . . Reinsurance only exists where a primary insurer becomes a ‘reinsured’ by entering into a contract with another insurer, the ‘reinsurer.’

See STARING, supra note 20, § 1:5, at 9-10 (“Reinsurance is not coinsurance, which is the relationship that results when separate insurers, either severally or jointly, assume direct shares of a given risk; in that case, all the insurers have a direct contract with the insured. It also is not a partnership, co-venture, or syndication, even though the contract may contain clauses creating or permitting joint responsibilities or control, as well as joint loss, since true reinsurance lacks essential characteristics of those relationships.”).

Id. at 10 (“Neither is reinsurance banking, although it performs a function of banking by providing the amortization of insurance losses and may, in effect, finance the growth of the reinsured.”).

Risk is transferred by a variety of financial transactions, not all, or even most of which, constitute insurance. Though insurance itself remains a somewhat elusive definitional concept, the indemnity function, particularly when combined with some aspect of fortuity is often seen as core insurance principles. See PLITT, supra note 9, § 9:24. (“Because the reinsurance agreement is a contract of indemnity, the liability of the reinsurer is inextricably tied to the loss of the reinsured.”); OSTRAGER & NEWMAN, supra note 10, § 15.01[a], at 990; Travelers Idem. Co. v. Scor Reins. Co., 62 F.3d 74, 76 (2d Cir. 1995) (Reinsurance is generally understood as a contract for indemnity not one of liability); Transcont’l Underwriters Agency v. Am. Agency Underwriters, 680 F.2d 298, 299 n.2 (3d Cir. 1982).
Importantly for our later discussions, the liabilities covered under a reinsuring agreement can extend beyond the cost of direct losses accrued by the cedent insurer's policyholder under the original policy to include such things as the cedent's costs of investigation and settlement of claims. Examples of other potentially indemnified insurer losses can even include losses arising from the reinsured's own bad faith—such as "judgments in excess of loss" costs and extracontractual, tortious bad faith liability.

B. A BRIEF TAXONOMY OF REINSURANCE

As reinsurance is a contractual arrangement, the nature, complexity and terms of many contracts stray from the standardization common among primary insurance policies. In fact, because of reinsurance's remarkable flexibility and its capacity to take on a large variety of risk types and risk levels, the policies vary in their purposes and specifics. The terms of the reinsurance contract and the terms of the policies reinsured determines the scope of the indemnity offered by the reinsurer. The contracts reflect the business needs of sophisticated commercial entities and, as such, the terms,

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33 PLITT, supra note 9, § 9:24 ("It is the language of the reinsurance contract that will ultimately determine the extent of the reinsurer's liability to the reinsured. In other words, the sustaining of a loss by the original insured cannot create liability for the reinsurer extending beyond the terms of its contract"). See also STARING, supra note 20, § 15:1, at 1 ("It does not necessarily follow that, where the first insurer is liable, the reinsurer is also liable. Whether or not the reinsurer is liable depends upon the terms of the contract of reinsurance.").

34 See PLITT, supra note 9, § 9:30.

35 See OSTRAGER & NEWMAN, supra note 10, § 16.06[a], at 1045-1048.

36 See id. § 15.03[b], at 997 ("Reinsurance treaties and certificates vary considerably in their language and terms of coverage").

37 Id. ("Reinsurance treaties may contain 'follow the fortunes,' 'errors and omissions,' 'notice,' 'arbitration,' 'claims cooperation,' 'salvage and subrogation,' 'allocation of expenses,' 'extra contractual obligations,' 'punitive damages' and/or 'cut through clauses.' The wording of these clauses in different reinsurance certificates and treaties can also vary substantially.").

conditions and costs of a reinsurance contract are all negotiable. Various clauses such as "follow the forms" and "follow the settlements" or clauses for "extracontractual damages", all discussed later in further detail, are common to many reinsurance contracts. The interaction of various clauses and the reciprocal obligations of good faith will be discussed in Section IV as we review the performance standards required by the reinsurance agreement. First, in order to understand the purposes of reinsurance, we review a few of the common types of arrangements common to those agreements.

39 See NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE, supra note 8, at 40.01 ("The reinsurance relationship is evidenced by a written contract reflecting the negotiated terms. Although reinsurance contracts between different cedents and reinsurers can include clauses with similar purposes, the wording of particular provisions varies significantly, depending on the parties' specific needs, customs and practices.").

40 See REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 31 (noting "'follow the settlements' generally provides that a reinsurer must cover settlements made by the reinsured in a business like manner, provided the settlement is arguably within the terms of the reinsured's policy and the reinsurance agreement and the settlement is not affected by fraud, collusion or bad faith. It is an expectation that the reinsurer will abide by the reinsured's good faith determination to settle, rather than litigate, claims under a reinsured policy and not relitigate a reinsured's settlements ceded to the reinsurance agreement. The term is often used interchangeably with follow the fortunes, and there may be overlap between the affect of follow the settlements and follow the fortunes when the 'risk' is what generated the loss. Follow the settlements is focused on 'loss settlement', not necessarily tied to a 'risk determination' arising out of follow the fortunes.").

41 Id. at 29 (noting the definition of the term extra-contractual obligations as "in reinsurance, monetary awards or settlements against an insurer for its alleged wrongful conduct to its insured. Such payments required of an insurer to its insured are extra-contractual in that they are not covered in the underlying contract.").

42 See PLITT, supra note 9, § 9:3 ("There are two broad categories of reinsurance agreements: facultative reinsurance and treaty reinsurance.").
Facultative reinsurance is the most discrete form of reinsurance, and generally accepted as the likely original form of reinsurance. Facultative reinsurance policies take their name because the contracts allow the reinsurance company to use its "faculties" or reason to choose to reinsure a specific risk, a specific policy, or a specific group of policies. The ceding insurer and reinsurer agree to the terms and conditions of each individual contract. In these contracts, the reinsurer often conducts its own underwriting to determine the appropriate premium level. Facultative reinsurance contracts provide reinsurance for the unusual; they also have the greatest specific effect on the cost of covering unusual or

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43 See STARING, supra note 20, § 1:4 ("Facultative reinsurance of a single risk, which was undoubtedly the original type, continued dominant until the last half of the Nineteenth Century. A treaty, which is a long term contract covering more than one risk, is known to have existed as early as 1821. Treaties became common around the beginning of the Twentieth Century and one form, the excess of loss treaty, is said to have become widespread as a result of the San Francisco earthquake and fire of 1906").

44 See JERRY supra note 9, § 140[b], at 1054 ("Facultative reinsurance involves the primary insurer entering into an agreement for the reinsurance of a particular risk. The reinsurance can be written on a pro rata or an excess basis; the root word "faculty" denotes that the reinsurer has a choice of accepting or rejecting any risk proposed and of demanding whatever premium it thinks appropriate.").

45 See NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE, supra note 8, at § 40.04[1] ("The reinsurer and cedent negotiate the terms for each facultative certificate."). See also STARING, supra note 20, at §2:2 ("The prospective reinsured, either directly or through a broker, presents the direct policy terms, or a summary of them, and the proposal for reinsurance. If it is accepted at a satisfactory premium, a contract is made. Other terms are negotiated to the satisfaction of both parties.").

46 See STARING, supra note 20, § 2:6 ("The reinsurer will always have at least a general, if not a particular, interest in the integrity of the reinsured's underwriting and claims practices."). See also NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE, supra note 8, § 40.04[1] ("Facultative reinsurance is commonly purchased for large, unusual or catastrophic risks. Reinsurers thus must have the necessary resources to underwrite individual risks carefully.").
low-incidence risks. Likewise, with its ability to allow reinsurers to engage in significant underwriting operations prior to placing the policy, facultative reinsurance is often used to cover catastrophic or other low incidence – high loss risks. Individual risk facultative reinsurance may be used in tandem with the second variety of reinsuring agreements, the treaty.

ii. Treaty Reinsurance

Treaties are broad agreements that reinsurance multiple contracts, often contracts that have yet to be written by the direct insurer. Usually, treaties cover some portion or class of business of the direct insurer and historically may cover a long period of time, usually renewable on a fairly automatic basis unless one of the parties seeks a new term. Treaties are

47 See STARING, supra note 20, § 2:3, at 4 (“Once, no doubt, all reinsurance was facultative. With the rise of treaties, they account for great amounts of reinsurance but facultative reinsurance, which requires individual attention to underwriting, remains very important for businesses that fall outside the bounds of a treaty reinsurance program. The reinsured may want to meet competition and enter into new lines in which it has no expertise but can gain it through initially taking risks and obtaining facultative reinsurance from those who have experience. The reinsured may need facultative reinsurance where the risk falls under an exclusion in its treaties, either as to type or amount, or because the risk, although routine in nature, present a very high loss exposure. In the end, all these uses serve the general purpose of reinsurance to provide stability and promote growth.”).

48 See OSTRAGER & NEWMAN, supra note 10, § 15.01[b] (“The availability of reinsurance enables an insurer to accept risks that would otherwise be beyond its underwriting capacity by allowing the ceding insurer to ‘lay-off’ on reinsurers a portion of the risk of loss. Thus, reinsurance enables insurers to spread the risk of catastrophic losses among a larger pool of insurers.”).

49 See New Appleman Insurance Law Practice Guide, supra note 8, at § 40.04[1].

50 JERRY supra note 9, § 140[b], at 1054.

51 Id. (“Most reinsurance is treaty reinsurance. The treaty arrangement, sometimes called “automatic reinsurance,” involves a commitment of a reinsurer to assume part of the risk of the primary insurer, either on a pro rata or an excess basis, for a stated period.”).
particularly useful reinsuring mechanisms since they can be structured to reinsure losses on direct insurance which either were written during the term of the treaty but occur later, or they can be structured to reinsure losses that occur during the term of treaty but were written earlier.\textsuperscript{52} Likewise, the premiums may be calculated in a variety of ways including structuring the reinsurance premium in some way directly related to the premiums on the underlying policies or assigning a single sum or some other variable amount as the parties wish and which reflect their business purposes.\textsuperscript{53} Generally speaking, the treaty reinsurance contract forms when the original insurer cedes part of the premiums for its policies and the risk of losses on those policies to the reinsurer.\textsuperscript{54} Treaty reinsurance usually involves multiple reinsurers taking part of a book of the business’ risks, with each agreeing to assume a portion of the risk in some pre-determined manner.\textsuperscript{55}

Importantly, reinsurance treaties cover all risks written by the reinsured that fall within their terms unless specifically excluded.\textsuperscript{56} For this reason, treaty reinsurers generally do not review the individual risks underlying the treaty and do not conduct their own underwriting of the

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\textsuperscript{52} See STARING, supra note 20, § 2:4, at 4-5.

\textsuperscript{53} Id. at 5 ("Depending again on its structure and purpose, the premiums may be directly related to the premiums on the underlying insurance or may be lump sums, or variable amounts, not based on direct participation in the underlying premiums.").

\textsuperscript{54} OSTRAGER & NEWMAN, supra note 10, § 15.03[a], at 996. ("The reinsurer, under a single contract, agrees to indemnify the ceding insurer with respect to an entire ‘book’ of the ceding insurer’s underwriting activities for designated lines of insurance. A treaty reinsurance contract is formed when the primary insurer cedes part of the premiums for its policies and the losses on those policies to a reinsurer.").

\textsuperscript{55} Id. ("Arrangements typically involve the participation of numerous reinsurers, each agreeing to assume a percentage of the total liability under a single treaty.").

\textsuperscript{56} See NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE, supra note 8, § 40.04, at 17. ("Reinsurance treaties cover all of the risks written by the ceding insurer that fall within their terms unless exposures are specifically excluded. Thus, in most cases, neither the cedent nor the reinsurer has the ‘faculty’ to exclude from a treaty a risk that fits within the treaty terms.").
Rather, they rely on the underwriting experience of the original insurer, with a prudent reinsurer investigating the underwriting philosophy, loss experience, attitude towards claims management and other business practices. Facultative reinsurance can be combined with treaty reinsurance to cover exclusions in the treaty or for other business purposes, some of which we explore later.

iii. The Verticals and Horizontals of Reinsurance: Pro-rata and Excess of Loss

Again, we recognize along with the United States Supreme Court that:

In indemnity reinsurance . . . [the reinsurer] agrees to indemnify, or reimburse, the ceding company for a specified percentage of the claims and expenses attributable to claims that have been reinsured.

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57 Id. ("Treaty reinsurers rely heavily on the cedent's underwriting.").

58 REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 7. ("While treaty reinsurance does not require review of individual risks by the reinsurer, it demands a careful review of the underwriting philosophy, practice and historical experience of the ceding insurer, including a thoughtful evaluation of the company's attitude toward claims management, engineering control, as well as the management's general background, expertise and planned objectives.").

59 See REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 29, 54. (Noting the definition of treaty reinsurance is "is a reinsurance contract under which the reinsured company agrees to cede and the reinsurer agrees to assume risks of a particular class or classes of businesses" and the definition of facultative reinsurance is "reinsurance of individual risks by offer and acceptance wherein the reinsurer retains the ability to accept or reject each risk offered by the ceding company.").

The insured's indemnification by the reinsured need not be total or complete. In fact, the ability of reinsurers to take only a portion of a risk or book of risks is one of the particularly useful risk spreading-elements of reinsurance. There is nothing to prevent a single reinsurer from taking all indemnity responsibility for a policy or group of policies, but most reinsuring agreements take responsibility for only a portion of those losses. Traditionally, the responsibilities divide into two basic divisional structures most easily visualized as either a vertical or horizontal slicing up

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61 See REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 1 ("Reinsurance is a transaction in which one insurance company indemnifies, for a premium, another insurance company against all or part of the loss that it may sustain under its policy or policies of insurance").

62 Id. ("The fundamental objective of insurance, to spread the risk so that no single entity finds itself saddled with a financial burden beyond its ability to pay, is enhanced by reinsurance."). See also NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE, supra note 8 ("Reinsurance relationships can be simple or complex. A cedent can cede certain loss exposures under one contract or purchase several contracts covering different aspects or portions of the same policy to achieve the desired degree of coverage. A layering process involving two or more reinsurance agreements is commonly employed to obtain sufficient monetary limits of reinsurance protection. When a claim is presented, the reinsurers respond in a predetermined order to cover the loss.").

63 See PLITT, supra note 9, § 9:1, at 3-4 ("Reinsurance is a contract whereby one insurer transfers or 'cedes' to another insurer all or part of the risk it has assumed under a separate or distinct policy or group of policies in exchange for a portion of the premium.").
of the losses from particular risks assumed. Both facultative and treaty reinsurance can be written in either a pro-rata or excess of loss basis.

C. PRO-RATA AND EXCESS OF LOSS

If a reinsurer does not want indemnification responsibility for an entire risk classification or group of policies, it can structure the treaty to take on only a specific portion of each risk to which it applies. Using a pro-rata reinsurance contract, the reinsurer agrees to indemnify the ceding insurer for a percentage of original risk losses in exchange for a corresponding portion of the premium. Generally, pro-rata agreements

64 See REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 1 ("Reinsurance may be written on either a proportional basis or excess of loss basis. A reinsurance contract written on a proportional basis simply prorates all premiums, losses and expenses between the insurer and the reinsurer on a pre-arranged basis. The proportional approach is used extensively in property reinsurance. Excess of loss contracts, on the other hand, require the primary insurer to keep all losses up to a predetermined level of retention, and the reinsurer to reimburse the company for any losses above that level of retention, up to the limits of the reinsurance contract. In simplest terms, a retention is analogous to the deductible a policyholder may have on a personal insurance policy, such as an automobile or homeowner's policy.").

65 See OSTRAGER & NEWMAN, supra note 10, §15.03[a], at 996 ("Both treaty reinsurance and facultative reinsurance can be written on either a pro-rata or excess-of-loss basis. Treaty reinsurance involves an ongoing agreement between two insurers, binding in advance one to cede and the other to accept specified business that is the subject of the treaty. Facultative reinsurance is negotiated with respect to a specific risk insured by a particular policy or policies."). See also REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 7.

66 See REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 10 ("Under proportional reinsurance, the ceding insurer and the reinsurer automatically share all premiums and losses covered by the contract on a pre-agreed basis, thus there are no characteristics uniquely attributable to the risk associated with proportional reinsurance.").

67 See OSTRAGER & NEWMAN, supra note 10, § 15.02[a], at 993 ("Pursuant to a pro-rata reinsurance contract, the reinsurer agrees to indemnify the ceding insurer for a percentage of any losses from the original risk in return for a corresponding portion of the premium for the original risk.").
obligate the reinsurer to indemnify an insurer without requiring any retention by the reinsured. Commonly, this type of pro-rata arrangement is called Quota Share Reinsurance, where the ceding company indemnifies the cedent insurer for a fixed percentage of loss on all policies of a defined risk type. This easily visualized apportionment can become somewhat more complex in that a “pro-rata” treaty can also be horizontally segmented within each “slice” by requiring the ceding insurer to retain some portion of the loss with the reinsurer only responsible for the surplus. This type of pro-rata reinsuring up to the amount of insurance originally written, minus the ceding insurer’s retention is commonly called Surplus Share Reinsurance. With the entrance of additional retrocessionaires there can be quite a bit of segmentation in this surplus line.

68 See Ott v. All-Star Ins. Corp., 299 N.W.2d 839, 843 (Wis. 1981); Central Nat’l Ins. Co. v. Devonshire Coverage Corp., 426 F. Supp. 7, 11 n. 5, 21 (D. Neb. 1976), aff’d in part and remanded, 565 F.2d 490 (8th Cir. 1977). See also OSTRAGER & NEWMAN, supra note 10, § 15.02[a], at 993 (“Pro-rata reinsurance arrangements generally obligate the reinsurer to pay a proportion of any losses that occur with no retention by the reinsured.”).

69 See JERRY, supra note 9, § 140[b], at 1054-1055 (“Pro rata reinsurance, sometimes called ‘quota share’ reinsurance, means that losses, premiums, and expenses are divided pro rata by the primary insurer and the reinsurer. For example, the primary insurer may retain sixty percent of the risk and transfer forty percent. If any loss occurs, whether large or small, the primary insurer is liable for sixty percent of the loss and the reinsurer is liable for forty percent.”). See also OSTRAGER & NEWMAN, supra note 10, § 15.02[a], at 993 (noting quota share reinsurance “indemnifies the ceding insurer for a fixed percentage of loss for all policies of a defined type written by the ceding company.”).

70 JERRY, supra note 9, § 140[b] at 1055. (“A special kind of pro rata reinsurance is ‘surplus reinsurance.’ Under surplus reinsurance, the reinsurer agrees to cover a share of the risk that varies with the size of the exposure. For example, the treaty might specify that losses under $50,000 are covered in full by the primary insurer, that the first $50,000 of losses between $50,000 and $250,000 is paid by the direct insurer and the rest by the reinsurer, and that losses exceeding $250,000 are paid 20 percent by the direct insurer and 80 percent by the reinsurer.”).

71 See OSTRAGER & NEWMAN, supra note 10, § 15.02[a], at 993 (noting surplus share reinsurance “indemnifies the ceding insurer for a fixed percentage of loss for all policies of a defined type written by the ceding company.”).
Another interesting aspect of pro-rata treaties is the reinsured's obligation to automatically accept its portion of the risks insured. Pro-rata treaties come in a variety of broad types, knowledge of each of which is useful for our later discussion. For instance, the treaty can be pro-rata and obligatory. Through this structure, all risks in a specified category are shared automatically by some proportion agreed to. Pro-rata treaties often allocate a portion of the original premium to the reinsurer.

In the excess of loss reinsurance scenario, the reinsurer's obligation is defined in relation to the reinsured's retention. In this structure the reinsurer, subject to specific stated limits of coverage, indemnifies the reinsured for all or a stated portion of losses in excess of the agreed upon retention. The agreements can be structured so that the reinsurance can

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72 See New Appleman Insurance Law Practice Guide, supra note 8, § 40.04[2], at 16 ("Proportional or pro-rata reinsurance is characterized by a proportional division of liability and premium between the ceding company and the reinsurer.").

73 Id. ("The cedent pays the reinsurer a predetermined share of the premium, and the reinsurer indemnifies the cedent for a like share of the loss and the expense incurred by the cedent in its defense and settlement of claims (the 'allocated loss adjustment expense' or 'LAE').").

74 Id. ("According to the percentage agreed, the cedent and reinsurer share the premium and losses from the business reinsured.").

75 See Ostrager & Newman, supra note 10, § 15.02[a], at 993 ("Pursuant to a pro-rata reinsurance contract, the reinsurer agrees to indemnify the ceding insurer for a percentage of any losses from the original risk in return for a corresponding portion of the premium for the original risk. Pro-rata reinsurance arrangements generally obligate the reinsurer to pay a proportion of any losses that occur with no retention by the reinsured.").

76 See Staring, supra note 20, at 4 ("Whether the contract is pro rata or excess, the reinsured will...be expected ordinarily to retain a sufficient amount of the risk to give the reinsurer confidence that the policy will be well administered.").

be excess to the specific risk, specific occurrence, an aggregate dollar amount or specified loss ratio.\textsuperscript{78}

\section*{III. PURPOSES OF REINSURANCE}

A comprehensive review of all the reasons an insurer may seek to reinsure is not possible or necessary for the purposes of this Essay. Suffice it to say that as reinsurance is a flexible medium and supports a variety of functions, the purpose of acquiring it will differ in accordance with the business interests of the insurer seeking it.\textsuperscript{79} Likewise, as reinsurance serves a variety of purely financial and accounting purposes, reinsurance may be employed for purposes slightly beyond the scope of this Essay’s interest in its potential regulatory effects on insurance companies as insuring companies, rather than as financial institutions. Regardless, in accordance with our focus on the potential effects of reinsurance on primary insurers, it is useful to review the four main purposes for which reinsurance is generally sought in relation to the primary insurer’s insurance function.\textsuperscript{80}

\textsuperscript{78} OSTRAGER & NEWMAN, § 15.02[b], at 994 (noting per risk or specific excess reinsurance “indemnifies the ceding insurer, subject to a specified limit, against the amount of loss in excess of a specified retention with respect to each risk covered by a reinsurance arrangement”; per occurrence reinsurance “indemnifies the ceding insurer, subject to a specified limit, against the amount of loss in excess of a specified retention with respect to each occurrence”; aggregate excess of loss reinsurance “indemnifies the ceding insurer for the amount by which the ceding insurer’s loss during a specified period exceeds either (a) a specific dollar amount or (b) a percentage of the company’s subject premium”; and stop loss reinsurance “indemnifies the ceding insurer for losses in excess of a specified loss ratio up to a predetermined loss ratio limit.”).

\textsuperscript{79} See REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 3 (“Depending on the ceding company’s goals, different types of reinsurance contracts are available to bring about the desired result.”).

\textsuperscript{80} Id. (Insurers purchase reinsurance for essentially four reasons: (1) to limit liability on specific risks; (2) to stabilize loss experience; (3) to protect against catastrophes; and (4) to increase capacity.”).
A. RISK ALLOCATION

For some purposes, reinsurance serves the almost identical purpose for the reinsured insurance company as that of many other common commercial insurances. Thus, reinsurance’s initial purpose may be viewed as a basic reallocation of risk and as an additional way to spread risk. Just as any commercial entity might enter the insurance market seeking indemnity for specific types of loss, so too does the insurer seek a mechanism to transfer the risk it chose to underwrite to another party. In a reinsurance situation, the risk acquired by the ceding insurer transfers to the reinsurer to the extent and within the limits of the negotiated contract; to the extent that those risks are allocated among numerous reinsurers, the risk is spread even further.

This risk transfer benefits the insurer by allowing the reinsured to take action that might otherwise be prohibited or disallowed sans reinsurance. For instance, through the medium of reinsurance, the ceding

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81 *Id.* ("By providing a mechanism through which insurers limit their loss exposure to levels commensurate with their net assets, reinsurance enables insurance companies to offer coverage limits considerably higher than they could otherwise provide.").


83 REINSURANCE ASSOCIATION OF AMERICA, *supra* note 11, at 6. Importantly, it must be remembered that reinsurance does not actually lessen total risk exposure:

In any discussion of reinsurance, the limitations must be considered along with its advantages. Reinsurance does not change the inherent nature of a risk being insured. It cannot make a bad risk insurable or an exposure more predictable or desirable. And while reinsurance may limit an insurance company’s exposure to a risk, the total risk exposure is not altered through the use of reinsurance.

*Id.*

84 JERRY, *supra* note 9, § 141, at 1056 ("[R]einsurance permits an insurer to transfer large risks that it is unable to manage or that are simply too risky to another insurer.").
insurer can underwrite business that it might otherwise not have been able to undertake.\textsuperscript{85} Either the risk itself may simply be too large or the risk of loss might be unusual in some other way.\textsuperscript{86} By limiting their loss exposure through reinsurance, the reinsured can offer higher coverage limits than they could otherwise afford.\textsuperscript{87} Through this mechanism, smaller insurers have the capacity to compete with larger companies and offer their policyholders a broader array of coverage options.\textsuperscript{88}

Likewise, the insurer may want to enter business lines that present the possibility of some future unexpected losses the insurer is unwilling to retain beyond a specific retention.\textsuperscript{89} Either the possibility of a very great a

\begin{footnotesize}
\textsuperscript{85} Id. ("For example, an insurer that has a portfolio of coverage faces the risk that a large number of small losses of an unexpected, unexceptional nature may occur, thereby exceeding the insurer’s capacity to pay for them without suffering a loss.").

\textsuperscript{86} Id. ("The insurer faces the risk that a single catastrophic event, the precise timing of which is uncertain (e.g., an earthquake) may occur with devastating consequences to the insurer’s balance sheet.").

\textsuperscript{87} REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 3 ("In calculating an appropriate level of reinsurance, a company takes into account the amounts of its own available surplus, and determines its level of retention based on the amount of loss it can absorb financially. Surplus, sometimes referred to as policyholders’ surplus, is the amount by which the assets of an insurer exceed its liabilities. A company’s retention may range anywhere from a few thousand dollars to one million dollars or more. The loss exposure above the retention, up to the policy limits of the reinsurance contract, is indemnified by the reinsurer. In this manner, reinsurance helps to stabilize loss experience on individual risks, as well as on accumulated losses under many policies occurring during a specified period.").

\textsuperscript{88} Id. (noting reinsurance’s goal of limiting liability “is crucial because it allows all companies, large and small, to offer coverage limits to meet their policyholders’ needs. In this manner, reinsurance provides an avenue for small-to-medium size companies to compete with industry giants.").

\textsuperscript{89} JERRY, supra note 9, at § 141, at 1056-57 ("Just as reinsurance enables an insurer to take on new business, reinsurance can also be used to enable an insurer to leave a particular kind of business quickly. An insurer that wants to rid itself of a particular kind of coverage can solicit reinsurance for all of the insurance the carrier has written, which effectively takes the insurer out of the business and makes the reinsurer the insurer for all of the risks.").
\end{footnotesize}
number of small, unexpected losses or the possibility of a single, catastrophic loss which could overwhelm the insurer's balance sheet might cause a prudent insurer to acquire reinsurance to offset the risk of loss.\textsuperscript{90} This prudential risk-transferring purpose of reinsurance appropriately supports a decision to reinsure, even though the insurer believes (as it must) that its underwriting decisions are prudent and the premium appropriate. After all, sufficiently imprudent underwriting could well be a defense to reinsurance coverage.\textsuperscript{91} Still, even the most perspicacious of underwriters cannot foresee the unexpected; thus the prudential purpose of reinsurance.

\textsuperscript{90} Id. at 1056 ("When the primary insurer purchases reinsurance, it reduces the size of its potential losses, which reduces the size of the reserves it must maintain. Insurers, however, are not as interested in reducing reserves as they are in increasing their business. An insurer with the minimum allowable level of reserves and surplus (the amount an insurer is required to maintain in excess of reserves to meet unexpected losses) could not take on new business or enter new fields. However, reinsurance provides a solution: the insurer could write the coverage, transfer the risk to a reinsurer, and receive a commission from the reinsurer. The primary insurer adds no new liabilities, but its surplus increases by the amount of the commission. This increased surplus enables the primary insurer to write and retain additional coverage. Another way to view this transaction is that some of the excess capacity of the reinsurer is utilized by the business-garnering efforts of the primary insurer; in essence some excess capacity is transferred from the reinsurer to the primary insurer. For the small insurer who wants to grow, reinsurance is an important way to take on new business beyond its means and simultaneously increase its capacity.").

\textsuperscript{91} PLITT, supra note 9, at § 9:31, 80-1 ("The duty of good faith that runs between the parties to a reinsurance contract is essential to the reinsurance relationship. Stemming from the reinsurer's need to rely upon and not duplicate the reinsured's efforts in properly evaluating risks and handling claims, and reducing costs for both parties to the reinsurance contract. Due to these specific needs of the industry, the duty of utmost good faith in this context connotes a higher duty than the ordinary duty of good faith that is inherent in general contract law. Accordingly, it requires that the reinsured must disclose to the reinsurer all material facts which may affect the subject risk. The failure of a reinsured to disclose material facts to the reinsurer will warrant the rescission of a reinsurance contract.").
B. RESERVE REQUIREMENTS

A second purpose for reinsurance, one particularly importantly in the insurance regulatory context, is using reinsurance to reduce the amount of reserves an insurer must maintain, thus freeing the insurer up to write more policies.\textsuperscript{92} In purchasing reinsurance, the primary insurer reduces the size of its potential losses, which allows it to reduce its statutorily mandated reserves.\textsuperscript{93} Hence, if a primary insurer hits the threshold for the minimum allowable level of reserves plus surplus that it is statutorily required to maintain, the amount of new business open to it would be restricted. But, if the primary insurer purchased reinsurance, the primary would still be able to write new policies so long as it could transfer the risk to the reinsurer.\textsuperscript{94} In fact, since the reinsurer swaps the new risk in exchange for a commission, the primary insurer is frequently seen as acquiring no new liabilities, while its surplus is viewed as increasing by the amount of the reinsurer’s commission.\textsuperscript{95} The majority of public regulation governing reinsurers concerns itself with this aspect of the reinsuring relationship.\textsuperscript{96}

\textsuperscript{92} See Kemper Reins. Co. v. Corcoran (In re Midland Ins. Co.), 79 N.Y.2d 255, 258 (1992) (noting reinsurance allows “a primary insurer to reduce the amount of legally required reserves held for the protection of policyholders, and to increase the company’s ability to underwrite other policies or make other investments”).

\textsuperscript{93} See STARING, supra note 20 (“For the individual insurer, the purchase of reinsurance has any or all of a number of objectives. It will desire to limit the reserves it must maintain for losses on its ordinary business.”).

\textsuperscript{94} REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 4-5 (“When an insurance company issues a policy, the expenses associated with issuing that policy, such as taxes, agent commissions, and administrative expenses, are charged immediately against the company’s income, resulting in a decrease in surplus. Meanwhile, the premium collected must be set aside in an unearned premium reserve to be recognized as income over a period of time. This accounting procedure allows for strong solvency regulation; however, it ultimately leads to decreased capacity. As an insurance company sells more policies, it must pay more expenses from its surplus. Therefore, the company’s ability to write additional business is reduced.”).

\textsuperscript{95} Id. (“Insurers purchase reinsurance...to increase capacity.”).
i. Regulation of Reinsurance for Purposes of Solvency

Though by no means its sole purpose, much insurance regulation exists simply to decrease the likelihood of unexpected insurance company failure. Regulators typically identify the fiscal ramifications of wide-scale insurance failure as their justification for proper insurance regulation. Therefore, though permitting reinsurers to go unregulated in other aspects, regulators recognized that the potential insolvency of a reinsurer could affect the solvency of its reinsureds, and have therefore taken legislative action to minimize that risk.

This is no idle matter. Both the Transit Casualty Company and Mission Insurance Company failed due to insurance insolvency in the 1980's.\textsuperscript{97} The failure occurred in part because they could not collect from their reinsurers. To address this risk, the states all have various techniques in place to assure reinsurer solvency. If admitted or licensed in the state, the reinsurer must comport with certain reserve requirements of its own or, if foreign or unadmitted, states require the reinsurer to offer a bond sufficient to allay fears of not collecting on reinsurance agreements.\textsuperscript{98} If the company does not post a bond, the insurer cannot take advantage of reinsurance's ability to grant credit and expand reserves.

\textsuperscript{96} Since reserves are the primary way public regulators attempt to reduce the risk of insurer insolvency and default, a great amount of activity has occurred amongst and between regulators to devise statutory schemes that allow for protection of the reserves. \textit{See, e.g.}, \textbf{INVESTMENTS OF INSURERS MODEL ACT} § 22 (NAIC 2007). There has been some very interesting work on reinsurer chartering and on bonding requirements for foreign insurers reinsuring domestic primaries.


\textsuperscript{98} \textbf{REINSURANCE ASSOCIATION OF AMERICA}, \textit{supra} note 11, at 13 ("When overriding public policy concerns require regulatory involvement, however, nearly all states have adopted regulations affecting reinsurance contracts. An example of this type of regulatory involvement is the requirement of a standard insolvency clause, which allows the receiver of an insolvent insurer to collect on reinsurance contracts. While few states require the filing or approval of reinsurance contracts, indirect regulation of reinsurance contracts and rates does exist. For example, restrictions on insurance rates affect reinsurance rates. Generally, if the amount paid in the premium to the insurer is limited, the amount of premium paid under a quota share reinsurance contract may also be limited.").
Still, the multi-state system leads to some fears of inadequacy and redundancy. To address these issues, along with the perennial problem of construing the appropriate way for the states to share in the taxation of these transactions, the House of Representatives in June 2007 passed HR 1065, the Nonadmitted and Reinsurance Reform Act. The Senate companion bill, S 929, awaits consideration in the Senate. That legislation would create a single state authority to determine the appropriateness of reinsurance credit and reinsurer solvency assessment. The solvency assessment would be conducted by the reinsurer’s home state and the credit determination would be made solely by the ceding insurer’s domiciliary state. It is unclear how this alters the current regulatory system other than to encourage reinsurers or insurers to change their domiciles in search of a state whose regulation best comports with their needs, though it likely will assist in clarifying taxation. In any event, these Congressional efforts reflect an understanding of reinsurance’s direct effect on insurer’s solvency.

By this legislative activity, it is apparent the regulators are not entirely unaware of the financial effects a reinsurer default could have on reinsureds. Yet, this type of legislation is still limited to regulation of reinsurance only as a source of funds for the domestic insurer. Basically, it reflects a conceptualization of reinsurance as a mere contractually acquired source of capital. There is no attempt in the regulatory legislation to move beyond solvency and to address the effects the terms a reinsurance agreement may have on their reinsured’s performance as regards their underlying policyholders. So far as regulators appear concerned, their responsibility to regulate reinsurance ends with regulating solvency.


100 Id. (That legislation would grant exclusive regulatory authority for multi-state surplus lines and to the insured’s home state so as to restrict each transaction to a single set of regulatory oversight, rules and taxation).

101 Id.

102 Id.
C. RISK EXITS AND FRONTING

A third commonly accepted purpose of reinsurance allows the primary insurer to cease writing some policies. An insurer that seeks to exit a certain risk stream can be relieved of the risks of loss from those policies and exit that insurance market via appropriate reinsurance. This allows a certain amount of flexibility to insurers by allowing them to shift direction in their future business choices.

A few caveats are necessary here. By reinsuring the entire loss, the primary insurer generally has not freed itself from its direct responsibilities to its policyholders, despite even a 100% risk transfer to the reinsuring companies. In other words, though it may have successfully transferred the risks of loss, it did not transfer its servicing responsibilities to the reinsurer. Again, reinsurance is generally defined as a secondary indemnity agreement and the reinsurer does not usually assume a direct claims handling relationship with the policyholders of the reinsured. Reinsuring agreements can, however, include "cut-out" provisions, which allow a direct action by the policyholders against the reinsurer; provisions like these change the reinsuring relationship.

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103 JERRY, supra note 9, § 140[a], at 1056-57 ("Just as reinsurance enables an insurer to take on new business, reinsurance can also be used to enable an insurer to leave a particular kind of business quickly. An insurer that wants to rid itself of a particular kind of coverage can solicit reinsurance for all of the insurance the carrier has written, which effectively takes the insurer out of the business and makes the reinsurer the insurer for all of the risks.").

104 Id.

105 Id.

106 NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE, supra note 8, at § 40.01 ("In essence, reinsurance is insurance for insurance companies. It is a contractual arrangement under which an insurer secures coverage from a reinsurer for a potential loss to which it is exposed under insurance policies issued to original insureds. The risk indemnified against is the risk that the insurer will have to pay on the underlying insured risk. Because reinsurance is a contract of indemnity, absent specific cash-call provisions, the reinsurer is not required to pay under the contract until after the original insurer has paid a loss to its original insured.").

107 See REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 27 (noting the definition of the term 'cut-through endorsement' as "an endorsement to an
One benefit of the reinsurer’s role instead of the primary insurer role is that the reinsurer is generally free from direct original policyholder action. For this reason, the standards of contract performance and the mutual obligations of the reinsured and reinsurer differ in type and structure from that of policyholder and insurer. Some of these relationships and the differences of obligations are described in Section IV of this Essay. Too much direct interaction by the reinsurer and the original policyholder will force the reinsurer to be treated simply as an insurer of the policyholder, obviating some of the benefits and performance obligations associated with the reinsuring agreement, usually to the reinsurer’s detriment. Likewise, though there is nothing to prevent the kind of direct assumption of the primary insurer’s role, such a situation really is better understood as a novation of the original primary insurance policies, rather than the type of reinsurance agreement for business agility that is the more common purpose of seeking reinsurance for indemnity purposes.

Another brief caveat is also useful here. Placing reinsurance for 100% of a certain type of underwriting business for the purpose of exiting the business is likewise different from another type of 100% reinsuring agreement that displays certain similar characteristics. In “fronting agreements”, an insurer will enter into a policy with the understanding that another party, a reinsurer, will be responsible for the entire amount that it is required to pay under the policy.\(^{108}\) One New York court described a fronting agreement or “fronting cessation” as an arrangement where an insurer issues a policy on a risk “with an understanding that another party will insure it”.\(^{109}\) The purpose of these “fronting agreements” is to allow a reinsurer not qualified or licensed to do business in the state, the

\(^{108}\) See Reliance Ins. Co. v. Shriver, Inc., 224 F.3d 641, 643 (7th Cir. 2000) (describing a fronting agreement as a “well established ad perfectly legal scheme” where policies are issued by state-licensed insurance companies and then immediately reinsured to 100 percent of face value).

opportunity to profit from the sale of insurance transactions in that state.\footnote{110} Generally, the licensed insurer will receive a fee for acting as the "front"\footnote{111}. Despite the slightly pejorative terms used in this arrangement, there is nothing illegal in a domestic insurer acting as a front for the unauthorized insurer. In fact, so long as all other regulatory goals are met, these relationships can allow for a significant increase in insurance capacity.\footnote{112}

D. LOSS STABILITY

Finally, and perhaps most importantly, reinsurance is a mechanism for insurers to stabilize their profits and expected losses.\footnote{113} Insurance does and always has concerned risk.\footnote{114} Using reinsurance, the primary insurer can set a limit on its exposure by facultative insurance for any given risk, use a surplus treaty to create a ceiling on aggregate loss or determine its percentage of risk retained through a pro-rata arrangement.\footnote{115} In this way,

\begin{itemize}
  \item \footnote{112} NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE, supra note 8, at § 40.04[5] ("A licensed reinsurer can front for an unauthorized reinsurer or a reinsurance syndicate, to permit the ceding insurer to take credit for the reinsurance without need for security.").
  \item \footnote{113} JERRY, supra note 9, § 140[a], at 1057 ("A fourth purpose of reinsurance is to stabilize insurers' profits and losses.").
  \item \footnote{114} See REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 49 (noting the definition of the term 'risk' as "a term which defines uncertainty of loss, chance of loss, or the variance of actual from expected results as it relates to coverage provided under an insurance or reinsurance contract. Also the term is used to identify the object of insurance protection, e.g., a building, an automobile, a human life, or exposure to liability. In reinsurance, each ceding company customarily makes its own rules for defining a risk.").
  \item \footnote{115} REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 4 ("Insurers often seeks to reduce the wide swings in profits and loss margins inherent to the insurance business. These fluctuations result, in part, from the unique nature of insurance, which involves pricing a product whose actual cost will not be known
even cumulative losses can be restricted to designated limits. The insurer uses reinsurance as a form of stability control, enabling them to fulfill their obligations to policyholders in a continuous manner and potentially stabilize their profits.

IV. REINSURANCE AS PRIVATE REGULATOR

As we have seen, reinsurance is a flexible and multifunctional arrangement. If the benefits of reinsurance to insurers were not so attractive, this multinational, trillion dollar industry would not be nearly such a popular choice of insurers. Yet, the potential for reinsurance to affect the business conduct of insurers has not been among insurance regulatory concerns. This is likely because reinsurance is considered to consist of agreements between sufficiently sophisticated parties so as to require little formal regulatory oversight of the relationship. That conclusion, however, precludes the understanding that through the medium of contracting for reinsurance, the insurer subjects itself to limitations—a kind of private legislation—similar to that of a consumer policyholder with its insurer. Just as with primary insurance, the existence of a reinsurance agreement limits the options of insurer action if they wish to benefit from the reinsuring agreement.

116 JERRY, supra note 9, § 140[a], at 1057 ("Through reinsurance, the maximum losses on policies can be kept to manageable levels, and cumulative losses over a period of time can be kept within a designated limit.").

117 Corcoran v. Universal Reins. Corp., 713 F. Supp. 77, 82 (S.D.N.Y. 1989) ("Insurance companies depend upon reinsurance contracts for financial stability and hence their ability to fulfill their obligations under their policies.").

118 REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 4 ("Insurers often seek to reduce the wide swings in profit and loss margins inherent to the insurance business. These fluctuations result, in part, from the unique nature of insurance, which involves pricing a product whose actual cost will not be known until sometime in the future. Through reinsurance, insurers can reduce these fluctuations in loss experience, and stabilize the company’s overall results.").
This is so because the reinsurance agreement is not one without conditions. Those conditions include everything from offering the reinsurer access to its underwriting philosophy 119 and underwriting success rates, to providing defenses to reinsurance performance based on inadequate claims handling. Moreover, the sheer breadth of the advantages available to an insurer from reinsurance make it likely that a prudent insurer will keep in mind the requirements and interests of the reinsurance industry while setting its underwriting and claims handling mechanisms in place.120 Just like a consumer policyholder will seek to keep his losses down to attract lower cost insurance, so will an insurer strive to make itself attractive to reinsurers.

Importantly, it must be recognized that reinsurance is generally not a one-off deal. Rather, reinsurance agreements are entered into for a specific time and are often then renegotiated.121 When a party is aware that its conduct under one agreement will affect the terms of its next agreement, it can only be assumed that the party will seek to mitigate activities which could have a future negative financial effect. If one can agree on nothing else as regards the insurance industry, the capacity for these companies to consider their long term financial interests should be somewhat obvious.

Another aspect of this discussion is not just that insurers seek to make themselves fiscally attractive risks to their reinsurers, an activity that

119 See REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 57 (noting the definition of underwriting capacity as “[t]he maximum amount of money an insurer or reinsurer is willing to risk in a single loss event on a single risk or in a given period. The limit of capacity for an insurer or reinsurer that may also be imposed by law or regulatory authority.”).

120 See REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 3 (noting “[i]nsurers purchase reinsurance for essentially four reasons: (1) to limit liability on specific risks; (2) to stabilize loss experience; (3) to protect against catastrophes; and (4) to increase capacity. Depending on the ceding company’s goals, different types of reinsurance contracts are available to bring about the desired result.”).

121 See REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 13 (noting “reinsurance contracts must be shaped to the ceding insurer’s unique requirements. No two contracts are alike – all have marked variations in retention levels, coverages and exclusions. An insurance company’s needs for reinsurance depend on its book of business and financial and underwriting strategies. The reinsurance contract, and hence reinsurance premiums, must be individually tailored and determined by the parties.”).
any party seeking capital would undertake. Rather it is the identification that terms and standards common to the reinsurance relationship have the potential to affect insurance company action as regards their primary policyholder in areas that come within the bounds of current insurance regulatory interests. Specifically, insurer practices in underwriting and claims handling.

A. A BRIEF LOOK AT INSURANCE REGULATORY GOALS: THE IDEA OF "AEOQUUM ET BONUM".122

Insurance regulation seeks to achieve a complex set of goals through the regulation of insurance. Regulation, as discussed earlier, frequently concerns itself with issues of insurer solvency.123 This interest is not conceived of solely as an attempt to keep a lucrative industry functioning. Rather, insurer solvency regulation exists in large part to obviate the harm to insured policyholders who would be hurt as a result the insurer’s insolvency.124 Unlike many other types of transactions, insurance does not lend itself to being the type of product that can be replaced if, just as a policyholder should come to need the insurer to perform, the policyholder were to learn that its company has defaulted as a result of insolvency. Put even more plainly, if insufficient reserves cause an insurer to default as a result of too many claims being made, in a catastrophe scenario for example, the negative externalities of that default are potentially extreme.125

122 See BLACK’S LAW DICTIONARY 1383 (8th ed. 2004) (noting the term secundum aequum et bonum means “[a]ccording to what is just and good.”).

123 See REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 13 (noting “reinsurance regulation focuses on solvency.”).

124 See STARING, supra note 20, § 19, at 19-1(noting “[r]einsurance has certain advantages which accrue to the insured public as well...reinsurance coverage represents an added shield protecting a policyholder against uncompensated loss. This advantage to the insureds is realized most obviously in the event of the primary insurer’s insolvency. “Thus, from the perspective of an insured or policyholder, the insolvency of the primary insurer may make any reinsurance the only or de facto source of at least partial compensation for losses incurred.”).

125 See REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 4 (noting “[r]einsurance provides protection against catastrophic loss in much the same way
Solvency, however, is not the only goal of insurance regulation. Rather the mission of insurance regulators is also to assure consumers of fair treatment and protection from unfair trade practices. Fairness can be seen to include appropriate access to insurance and the prevention of impermissible discriminatory practices and other notions of consumer protection. Taken as a whole, this amorphous "public policy" regulatory interest has perhaps been best characterized by some academics as the insurance regulatory principle of "Aequum et Bonum".

Used to encompass a spectrum of "public good" regulatory objectives, the identification of this principle is a useful shorthand. These "public good" regulatory goals are translated into regulatory policy in a way that helps stabilize an insurer's loss experience. Insurers use reinsurance to protect against catastrophes in two ways. First, reinsurance protects against catastrophic financial loss resulting from a single event, such as the total fire loss of a large manufacturing plant. Second, reinsurance also protects against the aggregation of many smaller claims resulting from a single event, such as an earthquake or major hurricane, that affects many policyholders simultaneously. While the insurer is able to cover losses individually, the aggregate may be more than the insurer wishes to retain.

Insurance regulatory interests include the perennial issues of risk containment and default. However, risk of default is not the sole purview of insurance regulation. Included in regulatory efforts are issues of political interest, such as guaranteeing equitable access to insurance, and other redistributive and equitable normative policies. For example, the Connecticut Department of Insurance describes its mission as follows:

The mission of the Connecticut Insurance Department is to serve consumers in a professional and timely manner by providing assistance and information to the public and to policy makers, by regulating the insurance industry in a fair and efficient manner which promotes a competitive and financially sound insurance market for consumers, and by enforcing the insurance laws to ensure that consumers are treated fairly and are protected from unfair practices.


variety of ways and it has not escaped notice that "the objective of aequum et bonum is present in some degree to most systems of insurance law and regulation. It has many facets: It is equality. It is morality. It is fairness, equality, reasonableness. It may even be efficiency, economy, parsimony."\(^{128}\)

Generally this principle is reflected in the tripartite goals that rates not be "excessive, inadequate or unfairly discriminatory", the standard language in nearly every state's regulatory legislation.\(^{129}\) Likewise regulations prohibiting unfair trade practices in the handling of a claim are created in the interest of consumer protection and fairness.\(^{130}\) This can be seen to reflect a somewhat disjointed effort to stay true to the "public interest" as best as it can be defined by regulators and courts while at the same time offering a private industry an opportunity for profit in an industry demanding regulated solvency. For this reason, underwriting practices, the assignment of rates to the sale of insurance, and its corollary - claims handling - are within the purview of insurance regulatory interest.\(^{131}\)

In their regulatory efforts Insurance Commissioners have not apparently considered the potential effect reinsurance agreements could have on insurers performance of their obligations to their policyholders, nor does there appear to have been any systemic review of the public policy

\(^{128}\) Id.

\(^{129}\) This authorization for regulatory efforts in these identifiably somewhat conflicting and unclear goals is supported by the long standing identification of insurance as something other than a purely private contractual affair. As courts have long noted, "It is no longer open to question that the business of insurance is affected with a public interest . . . Neither the company nor a policyholder has the inviolate rights that characterize private contracts." Carpenter v. Pacific Mut. Life Ins. Co., 74 P.2d 761, 774 (Cal. 1937). Thus, "[t]he contract of the policyholder is subject to the reasonable exercise of the state's police power." Id. at 774-75.

\(^{130}\) See National Association of Insurance Commissioners, supra note 13 (noting the NAIC works in conjunction with state insurance regulators in serving the public interest and facilitating "the fair and equitable treatment of insurance consumers.").

\(^{131}\) See id. (noting fundamental insurance regulatory goals include protecting the public interest, promoting competitive markets, promoting the reliability, solvency, and financial solidity of insurance institutions, and supporting and improving state regulation of insurance.").
concerns implicated by the availability of reinsurance for coverage of bad-faith extracontractual damages as a matter of consumer protection. In the next sections, we will identify how the core principle of reinsurance agreements— the reciprocal duty of good faith— when taken in concert with other common reinsurance doctrines and practices, have the capability of influencing insurer behavior on an industry wide scale. Likewise, we will review how the court’s interpretation of these obligations have the potential to affect insurance claims handling decisions and practices. Finally, we will review a series of available reinsurance clauses that seem to be antithetical to consumer protection goals and reduction of coverage litigation.

B. GOOD FAITH AS A REGULATOR OF UNDERWRITING AND CLAIMS HANDLING PRACTICES

Reinsurance obliges the parties to act in good faith. In fact, in can be said that this duty of good faith— enforced by the courts— is the core principle by which reinsurance operates in its myriad forms.

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132 See Reinsurance Association of America, supra note 11, at 29 (noting the definition of extra-contractual obligations as “monetary awards or settlements against an insurer for its alleged wrongful conduct to its insured. Such payments required of an insurer to its insured are extra-contractual in that they are not covered in the underlying contract.”).

133 See PLITT, supra note 9, § 9:17, at 56-57 (noting “[d]uties of good faith and fair dealing run between the reinsurer and the reinsured much as they do between the initial insured and his or her insurer. This duty originates from the reinsurer’s need to rely upon and not duplicate the reinsured’s efforts in properly evaluating risks and handling claims, reducing costs for both parties to the reinsurance contract. Accordingly, this duty requires the reinsured to disclose to the reinsurer all material facts which may affect the subject risk.”).

134 See STARING, supra note 20, § 12:1, at 1-2 (“The long and well established tradition that reinsurance transactions are a matter of ‘utmost good faith’ between the parties has had a predictable effect on the preparation of reinsurance contracts... The typical reinsurance contract is a relatively short, concise document, noticeably lacking in the legalisms so characteristic of other types of contracts. This underlying assumption of utmost good faith allows the companies to draft a document that assumes both parties are so knowledgeable on the subject matter to be dealt with and possess such a degree of sophistication as to preclude the necessity got long, expository declarations of intent and implementation.”).
Importantly, courts reviewing this doctrine have often interpreted it to require specific insurance company behavior as a condition precedent to requiring reinsurer performance of its indemnity obligation. Hence, failure to act in good faith affords the reinsurer a defense to its reinsurance obligation. Since reinsurance is frequently only triggered by extremely large dollar value claims, preventing the release of its reinsurer for a lack of good faith behavior will undoubtedly be of paramount concern to a prudent insurance company.

i. The Duty of Good Faith in Underwriting

One of the strangest aspects of reinsurance is the often overlooked question of how reinsurance could ever exist without becoming cost prohibitive. If one were to simply think about reinsurance in terms of risk assessment, there seems little way that the addition of multiple new players in the insuring process would not add and continue adding to the cost of insurance. After all, due diligence is an expensive proposition. How could all these different reinsurance institutions capably evaluate the true risks of all the policies which they agree to reinsure, particularly in the treaty context, without accruing costs as large as, if not larger than, the original insurer? The answer is simply that in the reinsurance treaty context they simply do not engage in that kind of investigation, instead they rely on the underwriting skills of their reinsureds. Investigation costs are limited to

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136 See JERRY, supra note 9, § 142[c], at 1059 ("The primary insurer and reinsurer have a duty to deal with each other in good faith, and the reinsurer will have available to it the defense of misrepresentation, breach of warranty, fraud, or concealment in circumstances where the primary insurer's acts or neglect give rise to the defense.").

137 See PLITT, supra note 9, § 9:17, at 56-57 ("Duties of good faith and fair dealing run between the reinsurer and the reinsured much as they do between the initial insured and his or her insurer. This duty originates from the reinsurer's need to rely upon and not duplicate the reinsured's efforts in properly evaluating risks and handling claims, reducing costs for both parties to the reinsurance contract.").
delving into the potential reinsured’s loss experiences, underwriting skills and claims handling competence.\(^{139}\)

How is action like that considered prudent? As we have seen to our great dismay in the sub-prime mortgage crisis, the consequences of opaque risk acquisition can be remarkably severe. In reinsurance, the reciprocal obligations of good faith obviates this problem in the reinsurance context.\(^{140}\) In reinsurance, this duty often requires, “the most abundant good faith; absolute and perfect candor or openness and honesty; [including] the absence of any concealment or deception, however slight.”\(^{141}\) Viewing utmost good faith as appropriately sufficient to govern trillions of dollars of transactions is interesting in and of itself, yet, as the

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\(^{138}\) See STARING, supra note 20, § 2:6, at 7 (“The reinsurer will always have at least a general, if not a particular, interest in the integrity of the reinsured’s underwriting and claims practices.”).

\(^{139}\) Id.

\(^{140}\) See PLITT, supra note 9, at 57-58 (“[The duty of good faith] requires the reinsured to disclose to the reinsurer all material facts which may affect the subject risk. The extension of this duty of good faith is the related concept that reinsurers are generally bound by the reinsured’s good faith decision to pay a claim, commonly referred to as the ‘follow the settlements’ doctrine. The purpose for this rule is to prevent situations in which reinsurers, in attempt to deny coverage, use against the reinsured the same coverage arguments made by the reinsured against the original insured, essentially eroding the good faith relationship needed in the reinsurance context. The limiting factor, preventing the abuse of this doctrine, is the determination of whether the reinsured’s payment was made in good faith.”).

\(^{141}\) See JERRY, supra note 9, § 142[c], at 1060. (noting that good faith “is the position of reinsurers that their contracts are those of ‘utmost good faith.’ Utmost good faith contracts of any kind are so delicate in character and so susceptible of abuse that unusual precautions must be observed by both parties in their implementation. The business of reinsurance often involves considerable oral exchange of information between primary insurer and reinsurer, and the reliability of this information is very important. The resemblance of the customary practices to how business used to be conducted at the Lloyd’s Coffee House of old is unmistakable. The strict law of warranty which applied to the old transactions at Lloyd’s probably has something in common with the duty of ‘utmost good faith’ which applies in reinsurance. Both doctrines have the effect of ratcheting up the expectations contracting parties can reasonably possess with regard to the accuracy of information shared by the other party.”).
Second Circuit has noted, it is the core relationship that allows for reinsuring to profitably occur. As they explained:

Historically, the reinsurance market has relied on a practice of the exercise of good faith to decrease monitoring costs and ex ante contracting costs. Reinsurance works only if the sums of reinsurance premiums are less than the original insurance premium. Otherwise, the ceding insurer will not reinsure. For the reinsurance premiums to be less reinsurers cannot duplicate the costly but necessary efforts of the primary insurer in evaluating risks and handling claims. . . . Reinsurers are protected, however, by a large area of common interest with ceding insurers and by the tradition of utmost good faith, particularly in the sharing of information.142

In other words, in exchange for placing the reinsurance at a price less than the original premiums, the reinsurer is allowed to rely on the good faith of the reinsured.143 In order for treaty reinsurance to function economically, the reinsurer cannot duplicate the underwriting functions engaged in by insurers at the time they placed the original coverage.144

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143 See JERRY, supra note 9, § 142[c], at 1060. (“Not all insurance law doctrines are ratcheted up when it comes to reinsurance arrangements, however. As one court explained, ‘[r]einsurance contracts, unlike primary insurance contracts, are not contracts of adhesion. Rather, reinsurance involves two sophisticated business entities familiar with the business of reinsurance who bargain at arms-length for the terms in their contract.’ Thus, a rule like the notice-prejudice rule, which is designed to equalize the relationship between insured and primary insurer, may be deemed irrelevant to the reinsurance setting, and an insurer that fails to give timely notice to a reinsurer may find itself unable to defeat the reinsurer’s late notice defense on the ground that the reinsure failed to show prejudice.”).

144 See ERIC M. HOLMES & L. ANTHONY SUTIN, HOLMES’ APPLEMAN ON INSURANCE § 102.4(a) (2d ed. 2000) [hereinafter HOLMES’ APPLEMAN ON INSURANCE] (noting “[u]nderwriting is largely retrospective, focusing on the
However, that does not mean the reinsurer does not take an interest in the underwriting activities of its reinsureds. As explained by the Reinsurance Association of America:

While treaty reinsurance does not require review of individual risks by the reinsurer, it demands careful review of the underwriting philosophy, practice and historical experience of the ceding insurer, including a thoughtful evaluation of the company’s attitude toward claims management, engineering control, as well as the management’s general background, expertise and planned objectives.\(^{145}\)

Keeping these criteria in mind, it is difficult to imagine insurance companies would not create and institutionalize underwriting practices that are most likely to attract reinsurers if they want to benefit from reinsurance.\(^{146}\) Moreover, the reinsured company would want to ensure that it kept particularly good records of its underwriting efforts, as they are required by their good faith obligation to “disclose to the reinsurer all material facts which may affect the subject risk”.\(^{147}\)

So great is the reinsurer recognition of their risk in relying on the underwriting decisions of their reinsured’s that reinsurance contracts frequently include a clause which allows the reinsurer access to their reinsured’s “books and claims and underwriting files”,\(^{148}\) if it finds such an

\(^{145}\) See Reinsurance Association of America, supra note 11, at 7.

\(^{146}\) See STARING, supra note 20, § 2:6, at 7. (“The reinsurer will always have at least a general, if not a particular, interest in the integrity of the reinsured’s underwriting and claims practices.”).

\(^{147}\) See PLITT, supra note 9, § 9:17, at 57.

\(^{148}\) See STARING, supra note 20, § 15:8.
audit necessary. Known as “audit and inspection clauses”, these clauses require “the reinsured’s records relative to the contract sessions to be always open to the reinsurer at reasonable times.” These clauses offer an opportunity for the reinsurer to review their reinsured’s underwriting and claims handling practices to assure itself that the reinsured company is acting in conformance with its expectations and that the claims made on it come within scope of its reinsurance contract. By this method, reinsurer’s have the capacity to keep themselves abreast of their reinsured’s underwriting and claims handling practices in an ongoing manner, when such inquiry is reasonable. And, in the event of a dispute it allows them the opportunity for a direct audit.

ii. The Capacity of Reinsurance to Stifle Underwriting Innovation

The search for information implies the capacity for reaction. The interplay of the duty of good faith and audit clauses offer the reinsurer the opportunity to monitor their reinsured’s practices. Such monitoring has the capacity to influence the way in which reinsured’s create and apply their underwriting discretion. Particularly for smaller insurance companies, dependant on reinsurance to take on the larger risks, it would not be beneficial to adopt underwriting practices which stray too far from the industry’s accepted norm. Should such a company attempt it, undoubtedly the company would have to charge higher premiums in order

149 Id. (noting that this right is not without limits and does not permit access to all the reinsured’s books generally, rather the audit is limited to the scope of the relationship between the parties).

150 Id. (noting that audit and inspection clauses are found in both treaty and facultative agreements so that treaty reinsured must make available their relevant books and facultative reinsured’s must keep the reinsurer “advised at various levels of detail with respect to claims under the policy”).

151 See REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 5-6 (noting “reinsurers often provide insurers with a variety of other services. Some reinsurers provide guidance to insurers in underwriting, claims reserving and handling, investments, and even general management. These services are particularly important to smaller companies interested in entering new lines of insurance.”).
to entice reinsurers to take on their risks. Likewise, those companies which require greater amounts of reinsurance to comply with their reserve requirements could also be discouraged from adopting broader or unusual underwriting procedures.

The inclusion of the reinsurer's interest of "underwriting philosophy", "historical experience of the ceding insurer" and "attention to the attitude of claims management" suggest that to the extent the industry profits from and seeks reinsurance for its business interests, those interests will militate in favor of choices which may not be completely congruent with all aspects of the regulators objectives; particularly those objectives which come within the broad understanding of aequum et bonum. It is not beyond the realm of possibility that access to insurance could be restricted for less profitable groups or only offered at a higher cost, implicating notions of fairness.

Though reinsurance monitoring may have the capacity to somewhat stifle or raise the cost of innovation, perhaps even to the point of raising issues of unfairness, there may well be some positive public good from the effect of reinsurance monitoring of underwriting practices. Reinsurers' interest in the underwriting and claim handling processes of its reinsureds might well suffice as a strong financial incentive towards maintaining professional and non-biased underwriting practices - a regulatory goal. The reinsurer's sole interest is its own financial one. To that end, the industry will seek out and reward those insurers who most accurately measure and rate risks. Though the reinsurance industry may not have an active incentive to broaden access to insurance for public policy reasons, it also has no active disincentive to restrict the sale of properly underwritten policies. As a whole, reinsurers profit from having insurance policies available to reinsure. Given the capacity for reinsurance to assist small insurers to compete on an asset basis with larger companies,

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152 New insurance lines are often covered facultatively until a sufficient loss history is developed to attract treaty reinsurance. See Hoffman, supra note 3, at 771. ("Demand for facultative reinsurance also exists for new insurance lines, specialty lines, or insurance products that are developed to cover traditionally uninsured risks. Such risks and exposures, if accepted by a reinsurer, are likely to be accepted only on a facultative basis because they transcend existing actuarial and ratemaking techniques.").

153 See REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 48 (noting the term 'reserve' means "[a]n amount which is established to provide for payment of a future obligation.").
reinsurance's availability can act to support companies writing policies for previously underserviced policyholders. In any event, reinsurers' interest in the underwriting procedures of those they reinsure undoubtedly serves the pseudo-regulatory function of encouraging actuarially sound underwriting practices by rewarding those companies with greater access to reinsurance. For this reason alone, reinsurance can be perceived as effecting industry practice beyond questions of solvency.

iii. Reinsurer Monitoring of Underwriting History and the Potential

For Market Response, the risk of reinsurance rate consequences does appear to effect insurance industry practice. A look to the facultative reinsurance market suggests that insurers are very concerned in maintaining attractive loss histories and are sensitive to reinsurance costs when making underwriting decisions. Remember, facultative reinsurance is used to mitigate the effect of the phenomena of the unusual risk costing more than the easily forecastable risk and is usually placed when the risk would not be accepted under a treaty.154 Again, it is through facultative reinsurance that an insurer could acquire reinsurance for a specific risk, a specific policy or a specific group of policies.155 It is for this reason that facultative

154 See Hoffman, supra note 3, at 770-771 ("By definition facultative placements involve risks that fall outside the general parameters of a treaty reinsurance program. Facultative reinsurance is purchased by primary insurance companies, captives, or reinsurers to cover assumed business that, for one reason or another, will not be ceded to a treaty.").

155 See STARING, supra note 20, § 1:4 at 7-8. ("Facultative reinsurance of a single risk, which was undoubtedly the original type, continued dominant until the last half of the Nineteenth Century. A treaty, which is a long term contract covering more than one risk, is known to have existed as early as 1821. Treaties became common around the beginning of the Twentieth Century and one form, the excess of loss treaty, is said to have become widespread as a result of the San Francisco earthquake and fire of 1906."). See also JERRY, supra note 9, § 140[b], at 1054 ("Facultative reinsurance involves the primary insurer entering into an agreement for the reinsurance of a particular risk. The reinsurance can be written on a pro rata or an excess basis; the root word ‘faculty’ denotes that the reinsurer has a choice of accepting or rejecting any risk proposed and of demanding whatever premium it thinks appropriate.").
reinsurance "usually covers catastrophic or unusual risks". Facultative reinsurance, however, will likely be more expensive per risk than broader treaty reinsurance because with facultative reinsurance the reinsurer often employs "substantial personnel and technical resources" to underwrite those risks. Treaty reinsurance avoids this kind of cost.

Yet, it is common practice to combine treaty and facultative reinsurance to protect an insurer's loss history with its treaty reinsurer. Companies often use facultative insurance to protect loss histories even though reinsurance coverage for the facultative risk already existed under treaty reinsurance agreements. The insurer's strategic decision to enter the additional facultative agreement as a hedge against unexpected losses on a risk is done with an eye out to protect against losses which would otherwise have the capacity to trigger a renegotiation of the insurer's entire treaty or cause future treaties to be reinsured at a higher cost.

As an example, the Reinsurance Association of America describes a situation where in order to accommodate a policyholder, an insurer may agree to provide commercial automobile insurance coverage—a higher risk activity. The RAA argues that additional facultative reinsurance would be appropriate in this situation even if the treaty reinsurance the insurer had already placed did not exclude commercial activity.

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156 See Reinsurance Association of America, supra note 11, at 7.

157 Id. at 8.

158 See Reinsurance Association of America, Who We Are, http://reinsurance.org/i4a/pages/index.cfm?pageid=3615. (The RAA describes themselves as "...a national trade association, headquartered in Washington, D.C., that is committed to an activist agenda to represent the interests of the property and casualty reinsurance industry in Congress, state legislatures, and international forums.").

159 See Holmes' Appleman on Insurance, supra note 152, at §102.4(b) (noting "[a] facultative reinsurance contract is written to cover a specifically identified risk. Both the ceding insurer and the reinsurer have the option (or 'faculty,' from the Latin for ability) to affect reinsurance on a risk-by-risk basis. Neither is obligated to cede or assume any given risk.").

160 Id. (noting "reinsurance treaties are blanket agreements negotiated between an reinsured and a reinsurer under which reinsurance is automatically provided for all policies issued by the reinsured that meet the criteria of the treaty. Treaty reinsurance is sometimes (but rarely) called automatic reinsurance. When a treaty
automobile coverage to “protect its losses under applicable treaty agreements”. As the RAA points out, the facultative “rider” need not even be purchased from the treaty reinsurers, allowing those potential commercial automobile losses to be handled under a completely separate relationship. This suggests the overall cost of ongoing higher treaty premiums is sufficiently grave to encourage the additional cost of “double reinsuring” certain risks, even at the relatively higher specific cost of the facultative agreement.

In any event, this common choice to pair facultative with treaty reinsurance to protect loss histories\(^{161}\) supports the conclusion that reinsurance monitoring of loss histories does effect reinsurance choices. This monitoring of underwriting practices\(^{162}\) has the capacity to effect underwriting decisions holistically and possibly industry-wide as insurers choose to implement practices that conform to the reinsurance market’s interests and prevent them from making underwriting risks which may negatively affect their reinsurance opportunities. To an extent, this natural interplay of loss history with reinsurance costs can create a self-regulating and self-limiting tendency among certain insurers to produce loss histories lower than similarly situated insurers.

Whether this activity is congruent with all articulated insurance regulatory interests is open to question, but there certainly exists the potential for segmentation of the market and increased costs for some policyholders. The simplest way for insurers to decrease loss histories is to restrict their business to lower risk policyholders or limit their dollar exposure to those risks. A “cherry picked” book of business, for example

\(^{161}\) See id. (noting “a reinsured can structure an elaborate program of reinsurance using a combination of treaties and facultative contracts, using one or multiple reinsurers.”).

\(^{162}\) Not only are underwriting practices monitored on a general basis, but in conformity with the reinsurer’s need to rely on their reinsured’s underwriting expertise, the duty of good faith requires the reinsured to disclose to the reinsurer all material facts which may affect the insured risk. See OSTRAGER & NEWMAN, supra note 10, at § 16:03[a], at 1036-37 (“It is a basic obligation of a reinsured to disclose to potential reinsurers all material facts regarding the original risk of loss, and failure to do so renders a reinsurance agreement voidable or rescindable.”).
could attract more reinsurance interest; as a result, the cherry-picking insurer can charge lower premiums to gain an even bigger bowl of cherries.

To the extent that this segmentation would not have occurred but for the reinsurance interests, reinsurance can be seen as having an effect on underwriting. There would still be an interest in insuring and reinsuring lemons, of course, so long as they can and will pay higher premiums which could be shared with the reinsurer, but the potential for reinsurance pricing to encourage cherry-picking can be somewhat troubling. The competitive advantage an insurer can obtain through reduced reinsurance premiums may militate against the traditional benefits afforded by the law of large numbers. The insurer could determine their best option for profit lay in the reinsurance cost saving produced by the lower risks.

An insurer with a sufficiently broad market share and multi-line business, of course, could get what would amount to a “bulk discount” for placing most of its reinsurance business with one company. But, if smaller insurers took the “cherry” approach and were rewarded with sufficiently lower premiums to compete against even the “bulk” advantage, the move towards segmentation would start when the big insurer slowly (or even quickly) began to loose enough of its cherries to affect its loss history in a way significant enough to offset its “bulk” appeal to its reinsurers. Remember, the reinsurance market is extremely broad, with at least 50% of domestic insurers reinsured by foreign companies. There is likely always some reinsurer around with a taste for cherries.

Importantly, reinsurance’s effect on cherry-picked risk premiums does not always result in the company actually restricting their business to those “better” risks alone. There is no reason why reinsurance treaties must be structured so as to take the entire book of business for a certain type of risk, though they often are structured that way. An insurer could reinsure with one company for their “better” risks at the lower prices, seek a competitive advantage on the market, and move the worse risks into a

\[163\] See Reinsurance Association of America, supra note 11, at 1 (“Reinsurance can be purchased from three distinct sources: reinsurance companies located in the United States, reinsurance departments of U.S. primary insurance companies, and alien reinsurers that are located outside the U.S. and not licensed here. The ceding insurer may purchase reinsurance directly from a reinsurer or through a broker or reinsurance intermediary.”).

\[164\] See Holmes’ Appleman on Insurance, supra note 152, at § 102.4A, at 32 (noting “[a] treaty may be written to cover some or all of an insurer’s line of business”).
different book charged higher premiums; premiums sufficient to entice a different reinsurer. A different insurer could acquire better overall pricing by averaging the two pools, but it could face difficulty getting those cherries away from the segmented insurer, moving the whole market towards segmentation.

There is also the possibility that certain types of policyholders—likely corporate ones—which could be sufficiently attractive to an insurer so as to make the relative reinsurance benefits irrelevant. If, for example, the worse risks in one line were restricted to those who proved more profitable for the company on some other business basis, like companies interested in multi-line policies or companies which in some sense represent loss leaders, the higher reinsurance premiums could be offset for even those "worse" risks. This offset provides the book of business with a competitive advantage. Yet, even that potential benefit would have to be consistently reevaluated in relation to current market rates and costs of reinsurance. If the advantage of getting the big book of business did not offset the higher reinsurance rates, it would no longer be profitable, forcing the insurer to raise its rates across the board. And, just as with the possible loss of cherries scenarios described above, if another insurance company could convince the multi-line user it was better served by spinning off the insurance of its cherry risks for a significantly lower premium; such competition could again support a move toward segmentation.

Unfortunately, in all these scenarios, there exists the risk of identification of a certain class of generally unattractive risks with fewer insuring options other than higher premiums. Hence, restrictive underwriting in the search for lower reinsurance costs can be seen as having the capacity to self-support segmentation through beneficial reinsurance rates. To the extent that reinsurance was the "but for" cause of this segmentation and increased costs for certain classes of risks, reinsurance is acting as a regulator of insurance rates and should certainly come within governmental regulatory review.

It would be extremely interesting to identify empirically whether certain state actions, such as prohibiting coverage refusals to certain classes of policyholders in their state results in an initial spike in the cost of reinsurance for the reinsureds who must extend their underwriting in conformity with those new mandates. Likewise, it would be very interesting to determine how long, if at all, such a spike continued to exist and whether a new underwriting requirement became sufficiently common that the effect disappeared.
iv. Reinsurance Clauses, Doctrines and Their Effect on Claims Handling

As with underwriting, reinsurance has the capacity to influence the activities of reinsureds, or those seeking to become reinsureds, attitudes and actions in the claims handling process. Because of the manner in which the reinsured's good faith obligation has been interpreted by courts so as to offer the reinsurer a defense to its indemnity obligations, the proper handling of a potentially reinsurable claim is likely paramount to any prudent reinsured. Even though, as described below, the claims handling would have to be so poor to constitute some form of "negligence" to succeed as a defense, the risk of lost reinsurance funds is no small matter. Further, given the fact that claims handling processes and "philosophy" are reviewed as part of reinsurers' decision to reinsure (just as with underwriting), adoption of formalized claims handling processes which would assure compliance with the reinsurance "non-negligent" claims handling standard is not unlikely. As we will see, the actions which a court might construe as "negligent" handling and investigation of a claim are neither necessarily intuitive nor without cost.

v. Duty of Good Faith in Claims Handling and Court Interpretation

In order to understand how the courts became arbiters of insurance claims handling sufficiency requires some explanation of a few new reinsurance doctrines and clauses — particularly the loss settlements or follow the fortunes doctrine. Again, a key point to remember is that the

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165 See REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 57 (noting the term 'underwriting capacity' means "[t]he maximum amount of money an insurer or reinsurer is willing to risk in a single loss event on a single risk or in a given period. The limit of capacity for an insurer or reinsurer that may also be imposed by law or regulatory authority.").


167 See William C. Hoffman, Common Law of Reinsurance Loss Settlement Clauses: A Comparative Analysis of the Judicial Rule Enforcing the Reinsurer's
duty of good faith is mutual and has been interpreted to create a powerful judicially-supported standard of care when examining the insurer’s performance of its claims handling function.\(^1\)

Most reinsurance agreements requires the reinsurer to “follow the fortunes” or “follow the settlements” of its reinsureds. These obligations are somewhat intuitively understandably necessary so as to allow the proper functioning of reinsurance.\(^2\) In short, the “follow the fortunes” doctrine\(^3\) obligates a reinsurer to follow the underwriting fortunes of its

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\(^1\) See PLITT, supra note 9, at \(\S\) 9:17 (“Duties of good faith and fair dealing run between the reinsurer and the reinsured much as they do between the initial insured and his or her insurer.”).

\(^2\) These doctrines are often conjoined in court decisions leading to certain amount of confusion in their analysis. See e.g., Litho Color, Inc. v. Pac Employers Ins. Co., v. Home Ins. Co., 991 P.2d 638, 647 (Wash. Ct. App. 1999). This problem has been noted by both courts and commentators. See Aetna Cas. & Sur. Co. v. Home Ins. Co., 882 F. Supp. 1328, 1346 n.9 (S.D.N.Y. 1995) (noting that “[t]he term ‘follow the fortunes” has been used imprecisely to describe the reinsurer’s duty to follow the claims adjustment decisions of the ceding company, thereby giving rise to some ambiguity as to its meaning. ‘Follow the fortunes’ more accurately describes the obligation to follow the reinsured’s underwriting fortunes, whereas ‘follow the settlements’ refers to the duty to follow the actions of the cedent in adjusting and settling claims.”).

\(^3\) There is considerable debate as to whether there truly exists a “follow-the-fortunes” or “follow the settlements” doctrine in the absence of a “follow-the-fortunes” clause. Some treatises and courts identify a “doctrine”. See PLITT, supra note 9, at \(\S\) 9:17 (“reinsurers are generally bound by the reinsured’s good faith decision to pay a claim, commonly referred to as the ‘follow the settlements’ doctrine”) (discussing ReliaStar Life Ins. Co. v. IOA Re, Inc., 303 F.3d 874, 878 (8th Cir. 2002) (the follow the fortunes “doctrine posits that if the cedent has acted in good faith in handling the claims presented to it and in providing coverage of the claims, the reinsurer may not second guess the coverage decisions of the cedent”). Other commentators are explicit that in the absence of a general loss settlement or other “follow-the-fortunes clause” the nature of reinsurance as an indemnity contract prohibits an implied-in-law obligation to reinsure a loss settlement unless the reinsured can prove actual—as opposed to a good faith belief of—liability. See Hoffman, supra note 174, at 679. The courts are aware of the split authority on the
reinsured and pay its share of a loss sustained by its reinsured,\(^{171}\) according to the terms of the reinsurance contract.\(^ {172}\) This clause obligates a reinsurer to indemnify its reinsured for its good faith payment of all claims that arguably fall within the scope of the agreement — no “second guessing” allowed.\(^ {173}\) Likewise, a “follow the settlements” clause requires

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matter. For example, in Aetna Cas. & Sur. Co. v. Home Ins. Co., 882 F. Supp. 1328, 1349 (S.D.N.Y. 1995), the court, when finding in favor of the reinsured Aetna, stated:

Under Aetna’s theory, it is the settled custom and practice in the reinsurance industry that reinsurers follow settlements entered into between a ceding company and its insured, as long as the settlements are made in good faith after a reasonable investigation and do not involve ex gratia payments. Essentially, Aetna maintains that a reinsurer’s undertaking to follow the ceding company’s settlements is implicit in any contract of reinsurance, and enforceable even in the absence of an explicit loss settlements clause. Home responds that in the absence of a loss settlements clause, a reinsurer is not bound by a ceding company’s settlement of a coverage dispute without the consent of the reinsurer. The court agrees with Aetna (emphasis added).

The weight of authority appears to favor Aetna’s position, although the authorities admittedly do not speak with one voice. For example, Gerathewohl opines that the "fundamental follow-the-fortunes principle" generally applies irrespective of whether it is expressed in the contract of reinsurance, i.e., in a loss settlement clause.

\(^{171}\) A reinsurer is not, however, required to pay losses “squarely outside” the scope of the ceding insurers coverage. See OSTRAGER & NEWMAN, supra note 10 at § 16.01[a], at 1013.

\(^{172}\) See Commercial Union Ins. Co. v. Swiss Reins. Am. Corp., 413 F.3d 12, 1231 (1st Cir. 2005). The reinsurer cannot, however, be found liable for an amount in excess of the reinsurance limit of liability stated in the agreement. See Unigard Sec. Ins. Co., Inc. v. N. River Ins. Co., 4 F.3d 1049, 1070-71 (2d Cir. 1993). This includes the reinsurer’s liability for “expenses” as well as for the amount of the actual loss. See Excess Ins. Co. v. Factory Mut. Ins. Co., 882 N.E.2d 768, 774-75 (N.Y. 2004) (finding that a reinsurers obligation for expenses incurred while handling a loss is capped by the limit of liability in a facultative agreement regardless of the presence of a “follow the fortunes” clause).

\(^{173}\) See N. River Ins. Co. v. Cigna Reins. Co., 52 F.3d 1194 (3d Cir. 1995) (“Follow the fortunes’ clauses prevent reinsurers from second guessing good-faith
indemnification of the reinsured for good faith settlement decisions.\textsuperscript{174} Such broad grants of power by the reinsurer to the discretion of its reinsured is seen by the courts to require the insurer to comport with a standard of care appropriate to that level of reliance and in accordance with its good faith obligation. In its application, a reinsurer will only be bound by a reinsured’s claims decision if the reinsured’s decision was made in conformance with judicially created criteria for identifying insurer good faith.\textsuperscript{175} Specifically, the claims decision must have been made after a “reasonable, businesslike investigation” into the propriety of the claim settlements and obtaining de novo review of judgments of the reinsured’s liability to its insured.”). This standard, however, is not always completely clear in its application. See JERRY, supra note 9, at § 142[c], at 1061-62 (“The usual role of the reinsurer is to ‘follow the fortunes’ of the primary insurer as if the reinsurer were a party to the original insurance. Some courts insist that the reinsurance agreement have appropriate language placing this obligation on the reinsurer, while others presume that the reinsurer’s obligations follow the form (although in most certificates ‘follow the form’ language will be found). As the phrase suggests, the idea is that the reinsurer is to accept whatever settlements the primary insurer makes and participate and pay according to the reinsurance agreement the appropriate share of whatever judgments are entered that trigger the primary insurer’s liability. Difficulties can arise in determining exactly what ‘fortunes’ the reinsurer agreed to ‘follow,’ in that the reinsurer’s obligation to participate in whatever payments the primary insurer makes is not unlimited.”).

\textsuperscript{174} In general, “[w]hen the reinsurance agreement contains a ‘follow the settlements’ provision, the reinsurer will be bound by the settlement or compromise agreed by the cedent unless it can meet its burden of proving either that settlement was dishonestly arrived at, or that the reassured has failed to take all proper and business-like steps to have the amount of loss fairly and carefully ascertained.” OSTRAGER & NEWMAN, supra note 10, at § 16.01[b], at 1020. Unsurprisingly, there is some muddling of terms as regards the use of the word “settlement” in various clause formulae. See e.g. Mentor Ins. Co. (UK), Ltd., v. Norges Brannkasse, et al., 996 F.2d 506, 508, 516-17 (2d Cir. 1993) (construing a reinsurance policy which provided that it was “subject to all terms, clauses, conditions and settlements as original to require reinsurance “payment where cedent’s good faith payment is at least arguably within the scope of the insurance coverage that was reinsured” using a “follow-the-fortunes” analysis.).

\textsuperscript{175} See Hoffman, supra note 174, at 692-93 (noting “[d]ishonesty, including fraud, bad faith, and collusion, is a universally recognized defense to a loss settlement clause”).
prior to granting it, and where there was a "reasonable basis" to conclude the underlying claim was covered by the reinsured's policy as a matter of law.

Since the obligation of good faith is mutual, the courts allow that certain circumstances, indicative of a lack of good faith, are sufficient for the reinsurer to be released from its obligation to reinsure. In other words, the court seeks a way to make sure the reinsurer is not taken advantage of by its reinsured. Particularly in the investigation and handling of the claim, in the absence of a reasonable standard, the reinsured could foreseeably choose not to investigate the claim properly to the financial detriment of its reinsurer. For this reason, the courts require the positive duty of reasonable and businesslike investigation of the claim by the cedent company. In theory, this likely only further strengthens the already extant interest of the reinsured company to be sure it is actually liable for coverage prior to payment—another instance where reinsurance supports a public interest by incentivizing prudence. In practice however, the availability of a defense on these grounds may lead to a reinsured cedent being overcautious in its claims review and handling at considerable expense.

vi. The Case of Suter v. General Accident Ins. Co.

One "follow the settlements" case is particularly illuminating of the capacity of "poor" claims handling to release the reinsurer from its indemnity obligation. In Suter v. General Accident Ins. Co., the court focused on claims handling improprieties in its decision to release the

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178 Suter v. Gen. Accident Ins. Co. of Am., 2006 U.S. Dist. Lexis 48209 (D.N.J. July 14, 2006), vacated by, Goldman v. Gen. Accident Ins. Co. of Am., 2007 U.S. Dist. LEXIS 70406. Though this decision was vacated as a result of agreement by the parties prior to hearing by the Third Circuit, for purposes of a recent court's analysis of the requirement of reasonable "businesslike" claim handling and investigation it is helpful. Instances where a court determines that the claims investigation was insufficient are rare, making this case of particular value for its findings of fact and reasoning.
reinsurer of its obligation arising from the reinsured's settlement. The underling case and settlements involved product liability tort claims asserted against Pfizer, as the manufacturer of allegedly defective heart-valves, by patients who had received the potentially defective valves. The manufacturer was the original insured which settled claims with the consent of Integrity Insurance Company, the original excess insurer which sought indemnity from General Accident Insurance Company of America, its reinsurer.

Interestingly, the "claims handling" improprieties identified in this decision were all actually related to the reinsured excess insurer's legal acumen and choices made in evaluating and settling the claim. They primarily were issues involving the proper acquisition of independent coverage counsel and expert medical advice. The court determined that failure to seek certain types of legal counsel and take certain investigatory steps, given the complexity of the case, constituted "gross negligence".

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179 See id., at *77-85 (reviewing the actions of Mr. Reive, the Senior Claims Examiner for Integrity Insurance Company, excess insurance company whose reinsurance agreement with General Accident Insurance Company was the subject of the case).

180 Id. at *13-34.

181 Id. at *8-13 (Pfizer had a classic array of multi-tiered insurance policies in place, with the company self-insuring for the first $10 million of liability, followed by two primary policies issued by INA, the Insurance Company of North America, above which it had umbrella issued by Transit Casualty Company, along with excess policies issued by Integrity, the reinsured in this case. Id. The Integrity Policies "followed the form" of the Transit umbrella policies, making the policy language of the Transit policies the subject of interpretation to determine the scope of Integrity's liability. Id. at *10).

182 Id. at *34-66

183 Id. at *81-85. ("for a case of this legal and medical complexity industry standards required Integrity to first obtain expert medical advice as to when bodily injury actually occurred and to retain its own coverage counsel for an opinion as to the appropriate trigger of coverage. The failure to do so ... breached Integrity's duty to Generall Accident to make a reasonable, businesslike determination as to whether the Shiley Heart valve claims should have been allowed.").
The court cited the insurer’s reliance on another insurer’s counsel for its appraisal of potential liability as inappropriate. Likewise, it cited failure of the insurer to hire its own medical expert (again it had relied on another insurer’s expert) to advise on the heart-valves potential for bodily injury and a failure of the insurer to keep up to date on the laws of trigger of coverage as determinative factors. Relying on these claims settlement investigation failures, the court further determined that the insurer had failed “breached its duty to General accident [the reinsurer] to make a reasonable, businesslike determination as to whether the [heart valve] claims should have been allowed.”

The court also found the Pfizer claims beyond the scope of Integrity’s policies and Integrity’s settlement of the Pfizer claims to have been so grossly negligent so as to constitute bad-faith. As such, the reinsurer was freed from its presumptively applicable duty to follow the insurer’s settlement.

To those familiar with the tort litigation process, this demonstrates a privately assumed obligation’s effect on the legal process and litigation costs. By focusing on the insurer’s choice not to hire independent counsel or rely on other medical experts as grounds for release from reinsurance obligations, even in a case like Suter where such reliance was self-

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184 Suter v. Gen. Accident Ins. Co. of Am., 2006 U.S. Dist. Lexis 48209, at *84 (D.N.J. July 14, 2006). The court’s analysis of the “follow the settlements doctrine” requirement that the reinsured’s duty to make a reasonable, businesslike investigation noted:

What is a reasonable, businesslike investigation of course must depend on the facts of each case. The factual findings support the conclusion that Mr. Reive's investigation was anything but reasonable and businesslike. Mr. Reive's investigation of the Pfizer claim was superficial, relying as it did on Pfizer's position and opinions of Transit's counsel, which were even at times inaccurate. The defendant has demonstrated that Mr. Reive did not make the kind of reasonable and businesslike investigation that the circumstances required. Id.

185 Id. at *84-5.

186 Id. at *81-85.

187 Id. at *85.

188 Id. at *85-86.

189 Id.
evidently imprudent, the court explicitly allows the reinsurance contract obligation of reasonable investigation to affect the insurer’s business judgment to save the cost of its own counsel or experts. In effect, this type of decision will require the use of coverage counsel by each insurer implicated on a sufficiently “complex” claim that may implicate its reinsurance. It also has the potential to institutionalize the added cost of duplicative legal analysis and investigation of claims where reinsurance is implicated.

To be sure, the Suter case, involved a significantly complex area of bodily injury law where the opinions of qualified legal and medical experts would likely have been sensible. Likewise, the Integrity claims handler probably should have kept abreast of legal changes implicating its obligations, given that directly relevant decisions had been made. However, there is no evidence that Integrity’s claims handler had been acting collusively with any party, was attempting to perpetrate a fraud, or was not subjectively acting in good faith. The importance of the decision is in its recognition that the standard of competent and businesslike investigation will be one of industry standards, as discerned by the courts. It identifies how a generally common business practice can transform into a legal obligation. Though the court was not incorrect in identifying that the claims handlers ignorance may have been tantamount to malpractice in this instance, the decision has the capacity to effect business practices beyond the narrow fact situation of the ruling.

Though the application of the determined standard of care will always be fact specific to the situation reviewed for reasonableness, the capacity for a standard practice of requiring independent legal experts in “complex” cases could easily trickle down to “moderate” cases and then, perhaps, to “easy” coverage decisions. Even in cases where there would probably be little disagreement as to the likely value of the claims or medical evidence of causation, how could an insurer not be expected to cover its risk with duplicative legal opinions when the claim implicates its

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191 Good faith is a perquisite for application of a reinsurer’s indemnity obligations. See ReliaStar Life Ins. Co. v. IOA Re, Inc., 303 F.3d 874, 878 (8th Cir. 2002) (finding that “doctrine posits that if the cedent has acted in good faith in handling the claims presented to it and in providing coverage of the claims ‘the reinsurer may not second guess the coverage decisions of the cedent’”).
reinsurance? Regardless where the line is eventually drawn as a matter of industry practice, one way or another, the litigation costs will eventually be internalized by the obligated insurers and passed to policyholders in the form of higher premiums.

Moreover, as the decision in Suter stems from the universally applicable good faith obligation of the insurer to reasonably investigate as a predicate to the reinsurer’s performance under the reinsuring agreement, this duplicative effort could become simple industry practice for most claims in an overabundance of caution.\textsuperscript{192} Even if there is no reinsurer obligated on the particular claim, as discussed above, reinsurers investigate and monitor claims handling philosophy. It is possible that an insurer thinking about their future interest in reinsurance will take steps to ensure their claims handling demonstrates their history of operating in a non-grossly negligent manner and, if that requires a showing of the consistent use of its own independent medical experts and coverage counsel, such would likely be undertaken.

One caveat: it is of course possible that this added duplicative cost could be so cost prohibitive the insurer would prefer to simply avoid reinsurers and internalize the litigation savings. As described above, the benefits of reinsurance, particularly the ability to stabilize profits and leverage reserves makes such a choice unlikely.\textsuperscript{193} For various reasons, an insurer remains aware of the chance it will in future need reinsurance. If anything, knowingly producing largely duplicative legal work would simply lead insurers to pressure their attorneys to reduce the cost of redundant legal services, if it cannot reduce the need to complete the work in the first place. Perhaps this accounts for some of the insurance industry’s interest in creating legal services compensation structures which offer opportunities for “bulk rate” services and long-term billing agreements.


\textsuperscript{193} REINSURANCE ASSOCIATION OF AMERICA, supra note 11, at 4 (noting “[i]nsurers often seek to reduce the wide swings in profit and loss margins inherent to the insurance business. These fluctuations result, in part, from the unique nature of insurance, which involves pricing a product whose actual cost will not be known until sometime in the future. Through reinsurance, insurers can reduce these fluctuations in loss experience, and stabilize the company’s overall operating results.”).
C. Consumer Protection: Declaratory Judgments, Bad Faith and Reinsurance Coverage

Since reinsurance is considered a business to business transaction, it is subject to significantly less regulatory oversight beyond issues of solvency. As described above, however, reinsurance’s ability to indirectly affect the policyholder though inculcating and rewarding reinsurer-focused underwriting decisions and claims handling processes exist and current regulatory schemes do not address them. Yet they implicate issues of grave public policy. As described below, reinsurance clauses have been held valid so as to provide reinsurance for the bringing of a declaratory judgment action against the original insured to obviate coverage. Other approved clauses even allow for the reinsurance of judgments in excess of loss resulting from insurer bad faith and clauses which offer reinsurance for extracontractual damages arising from a bad faith tort suits. Each of these has the capacity to support rather than prohibit unfair insurance practices. If for no other reason than the moral hazard of reinsuring tortious conduct.

As regards declaratory judgments, many reinsurance agreements include a clause which states that the agreement covers “all expenses incurred in the investigation and settlements of claims or suits”. Such a clause makes sense in relation to the reinsurer’s interest in not indemnifying claims beyond the scope of the policy they are reinsuring. These clauses have been construed to reinsure the cost of declaratory judgments brought against the primary insured policyholder to obviate coverage. To an extent, it makes sense for the reinsured to seek to lay-off these declaratory judgment costs to the reinsurer where much of the benefit of the coverage determination would accrue to the reinsurer on the risk. However, the availability of such coverage can only incentivize an increased use of the declaratory judgment mechanism. In fact, given the broad reaching good faith obligation of the reinsured, failure to bring the declaratory judgment action could potentially be seen as negligent.

These clauses are very common and often interpreted broadly. Moreover, in the absence of an exclusion, the “standard practice” of the industry to allow for such costs can create a sufficient question of fact to

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194 See PLITT, supra note 9, at §9:29.

support an implied modification of the contract sufficient to defeat a motion for summary judgment. Likewise, despite the absence of a clause, declaratory judgment costs have been upheld as part of the contract as a result of the parties “custom and practice”.

Other particularly worrisome reinsurance clauses implicate insurer bad faith. For example, one available clause makes reinsurance coverage available for judgments in excess of policy limits arising out of the reinsured’s bad faith failure to settle or defend a claim and another allows for reinsurance of bad faith judgments and other extracontractual damages. Called “judgment in excess of policy limits” and “extracontractual obligations” clauses, these provisions allow insurers to be indemnified for their own bad faith actions against their policy holders.

As reported in Ostrager & Newman’s Handbook on Insurance Coverage Disputes, a judgment in excess of policy limits clause generally provides “in word or substance”:

It is agreed that should the ceding insurer become legally obligated to pay a loss in excess of policy limits by reason of alleged or actual negligence, fraud or bad faith in rejecting an offer of settlement or in the defense or trial of any action against an insured, the Reinsurer agrees to assume ____% of said loss [in excess of the ceding insurer’s] $ ____ retention.

These clauses are “relatively widely used and provide[] the reinsurer will participate in such excess verdicts but not to exceed the reinsurance contract limits”. Moreover, there are iterations of this clause which explicitly provide for coverage of “punitive damages”. Other courts have found reinsurer’s liable for extracontractual damages even in

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198 See OSTRAGER & NEWMAN, supra note 10, at § 16.06[a].

199 Id.

200 Id.

201 Id.
the absence of such a clause, but where the reinsurance agreement does contain the common "follow the fortunes" language.\textsuperscript{202}

The second bad faith related clause covering extracontractual obligations or ECO's differs from that of the "excess judgments clause" in that it directly allows for reinsurance indemnification for tortious insurer bad faith awards.\textsuperscript{203} Its purpose has been described thusly:

When an insurance company finds itself on the wrong side of a bad faith case, a judgment awarding punitive damages often results and the insurance company must pay the judgment out of its own funds unless it has insured itself, through reinsurance programs or other means, against punitive damages awards. Many reinsurance agreements have a special provision called an extracontractual obligations clause, which typically provides that the reinsurer will pay some percentage of the reinsured's liability for claims brought against it outside of the terms of underlying insurance contracts. It is well understood in the industry that the ECO clause is designed to respond to bad faith punitive damages awards against the reinsured.\textsuperscript{204}

Prior to the creation of ECO clauses, the ability of insurers to lay-off the costs of their own bad faith actions had been limited to the availability of reinsurance for only judgments in excess of policy limits. The ECO clause sought to broaden this limitation by extending reinsurance for tortious bad faith judgments as well as judgments in excess of policy limits.\textsuperscript{205} ECO clauses offer reinsurance coverage for an insurer's bad faith

\textsuperscript{202} \textit{Id.} (citing Peerless Ins. Co. v. Inland Mut. Ins. Co., 251 F.2d 696, 697 (4th Cir. 1958)).


\textsuperscript{205} \textit{Id.} at 159. ECO clauses made their first appearance in 1978 in response to the desire of primary insurers to secure coverage for the various tort claims that had evolved into extracontractual, i.e., bad faith liability. Bad faith liability arises separately from the coverage provisions of any underlying insurance policy or reinsurance agreement, and results solely from the tortious conduct of an insurer in the course of policyholder service or claims handling under the policy. Tortious conduct may include: (1) denial of a claim based on inadequate investigation; (2) intentional misrepresentation of a claim or policy; (3) false accusations against the insured; (4) failure to disclose the rights of the insured; (5) unfair marketing practices; (6) unreasonable rejection of an offer within the policy limits; and (7) agent misrepresentation or fraud. An extracontractual obligation also may be a
liability sounding in tort law, rather than arising from breach of the insurance contract. Hence, the reinsurance clause which provides coverage for those tortious damages refers to such finding of liability as an "extracontractual obligation". Such clauses first began to appear in 1978 as actions for tortious bad faith liability—and judgments—began to become more commonly accepted.

It appears obvious that the availability of reinsurance for bad faith tortious liability has the capacity to influence reinsured companies claims behavior. In fact, it appears to be an obvious moral hazard. A bad faith action can be grounded in a whole host of improper insurer activity when servicing a policyholder's claim. As one commentator noted, examples of bad faith tortious conduct could well include:

(1) denial of a claim based on inadequate investigation; (2) intentional misrepresentation of a claim or policy; (3) false accusations against the insured; (4) failure to disclose the rights of the insured; (5) unfair marketing practices; (6) unreasonable rejection of an offer within the policy limits; and (7) agent misrepresentation or fraud.206

It seems apparent that so far as there is a regulatory interest in preventing bad faith insurer behavior—an interest reflected in both statutory and common law—the capacity to reinsure bad faith judgments has the capacity to subvert that interest.

Considering that reinsurance agreements are supported by the premiums charged to policyholders, it seems somewhat incongruous to allow the cost of insurer's own bad faith judgments to be charged directly back to policyholders in their premiums. In fact, it seems to severely undermine the integral purpose of bad faith legal actions beyond the reinsured's own retention, to allow for them to be reinsurable.

Clearly, this type of indemnification reduces the deterrent value of these actions. There can be little deterrence through litigation and the award of damages, tortious or otherwise, if those judgments are indemnified by reinsurer's as a matter of course. Granted, reinsurers are sensitive to loss histories so too frequent a number of bad faith judgments could increase the insurer's costs to reinsure. Still, that market based result seems somewhat less than the affect contemplated by legislators who enact bad faith statutes and somewhat disjointed from traditional understanding of the purpose of the tort system. In any event, these clauses identify yet judgment in excess of the limits of an insurance policy, with the insured being liable for the excess due to the mishandling of the claim.
another possible contractual source of influence on reinsured’s claims handling behavior.

V. CONCLUSION

Reinsurance agreements certainly have the capacity to influence insurer behavior. The effect of these agreements and the manner in which courts enforce their performance likely leads to the institutionalization of systems beyond and not necessarily congruent with many of the expectations and avowed purposes of some regulatory activity.

Insurance is often dubbed an industry affecting the public interest; if that is so, then reinsurance should acquire that denomination as well. Though silent, operating through private contract alone, it has the capacity certainly to influence, if not directly regulate, insuring behavior. To be effective, this Essay suggests that regulatory discussions of the insurance industry be expanded to recognize the influential capacity of the reinsuring industry. To fail to do so is to ignore a fundamental financial influence on the entire insurance industry with the likely result that the silent regulator will continue to operate below the notice of our sometimes raucous public ones.