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THE U.S. CAPTIVE INSURER TREND – NEW CHALLENGES WITH RESPECT TO CLAIMS COOPERATION & NOTICE

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A. INTRODUCTION

There is a growing trend in the U.S. insurance markets to replace traditional commercial insurance with alternative risk transfer options, the most popular of which are captive insurance companies. The number of captive insurance companies domiciled in the U.S. alone now exceeds 1,400 and captive insurance companies underwrite nearly all types of coverage for their parent companies. This trend has resulted in more than 50% of U.S. States enacting captive insurance company enabling statutes. The prospect of favorable tax treatment, the ability to tailor coverage to specific needs and directly access the reinsurance market, the reduction of operation costs, and the ability to exercise greater control over claims and claims management has resulted in approximately 80% of Fortune 500 companies and a large majority of the major U.S. corporations utilizing captive insurers for at least part of their commercial insurance needs.

The U.S. captive insurer trend, and to a lesser extent the increased use of "fronting" insurance policies, raises concerns regarding the cedent's diligent and good faith handling of claims that may result in exposure under a reinsurance agreement. Unlike commercial insurers who have an independent interest in the proper handling of a claim, captive insurers and fronting insurers can be viewed as having no such independent interest and in some instances no true "risk." Captive insurers are oftentimes controlled by the insured/parent company that, in some cases, control the claims handling and may have ulterior motives that can negatively affect the handling and settlement of claims. Fronting insurers pose a risk to reinsurers in that the lack of risk retention by a fronting insurer could lead to impassive claims handling.

Given this trend, a reinsurer's rights under a reinsurance contract to prompt notification of claims and the cedent's cooperation are of critical importance. U.S. courts have interpreted the follow-the-fortunes clause to afford reasonable latitude to cedents in the settlement and

handling of claims, with limited exceptions under which a reinsurer can challenge a settlement. Therefore, reinsurers must be more diligent in enforcing their rights to notice and cooperation, including the right to associate in the defense of a claim and to obtain all relevant information and documents from the cedent. This is especially so with respect to claims and settlements tendered by cedents that are captive and fronting insurers. The alternative is that reinsurers presented with questionably-handled claims and settlements from captive insurers and fronting insurers face the significant burden under U.S. law of challenging the settlement on the grounds that the captive insurer or fronting company failed to settle in good faith or on the ground that the loss falls outside the coverage afforded under the reinsurance agreement.

In this paper, we discuss the status of U.S. law regarding a cedent's obligation to provide timely notice to a reinsurer. More specifically, we discuss U.S. law as to when a cedent's duty to provide notice is triggered, as well as the majority rule requiring a reinsurer to establish prejudice as a result of late notice in order to avoid its obligations under the reinsurance agreement in the absence of language requiring timely notice as a condition precedent. We further discuss U.S. courts' interpretation of the claims cooperation clause, including a reinsurer's right to associate in the defense or control of a claim and its right to obtain information and records from the cedent so as to properly evaluate a reinsurance claim.

B. THE CLAIMS COOPERATION CLAUSE AND THE LATE NOTICE DEFENSE

Although sometimes viewed as a distinct provision and obligation under a reinsurance agreement, a cedent's obligation to notify the reinsurer of a claim or loss is part and parcel with its obligation to cooperate with the reinsurer. Indeed, many reinsurance agreements include the cedent's notice obligations within the cooperation clause. Of course, a cedent's notification to a reinsurer of a claim or loss is a necessary first step in terms of its obligation to cooperate with the reinsurer. In that regard, late notice inevitably thwarts a reinsurer's right to cooperation from the cedent with respect to underlying claims as required by a claims cooperation clause. See Louis Torch, *An Examination of Reinsurers' Associations in Underlying Claims: The Iron Fist in the Velvet Glove?*, 3 Pierce L. Rev. 331, 342 (June 2005). Hence, the duty to timely notify the reinsurer of potential claims is, without a doubt, crucial to the preservation of a reinsurer's rights. Therefore, any analysis of a cedent's obligation to cooperate with a reinsurer begins with when notice must be given under the reinsurance agreement and the legal effects of a cedent's failure to timely notify a reinsurer of a claim or loss.

Claims cooperation clauses and notice provisions vary in form and substance from reinsurance agreement to reinsurance agreement. Some provisions expressly state that compliance is a condition precedent to coverage. Others require notice based on the actual loss or other objective criteria, such as a particular type of claim (*e.g.* death or brain injury) or a set dollar amount. More commonly, however, notice provisions require a cedent to "promptly" notify a reinsurer where a claim "may" or "appears likely" to involve the reinsurance. The following is an example of such a claims cooperation clause:

> The Company [cedent] shall advise Reinsurer promptly of any claim and any subsequent developments pertaining thereto which, in the opinion of the Company, may involve the reinsurance hereunder . . . . The Company, when so requested, will afford the Reinsurer an opportunity to be associated with the

> Company, at the expense of the Reinsurer, in the defense or control of any claim, suit or proceeding involving this reinsurance, and the Company and the Reinsurer shall cooperate in every respect in the defense and control of such claim, suit or proceeding.
>
> [British Ins. Co. of Cayman v. Safety Nat'l Cas., 335 F.3d 205, 207-08 (3d Cir. 2003)].

As is the case in all contract interpretation, the language of a reinsurance agreement plays an important role in its interpretation. For example, if a claims cooperation clause explicitly states that timely notice is a condition precedent, U.S. courts have held that a breach of the notice requirement will result in a forfeiture of reinsurance coverage even if the reinsurer has not suffered prejudice. See infra Point B.4. Absent express language that timely notice is a condition precedent, the majority of U.S. courts have required the reinsurer to establish that it has been prejudiced by the late notice. See infra Point B.2.

As discussed below, a reinsurer's late notice defense under U.S. law involves an analysis of several separate issues and U.S. courts' treatment of those issues. Those issues include the following: (1) when the cedent has a duty to notify the reinsurer of a claim under the terms of the reinsurance agreement; (2) whether the notice provision includes the express language that compliance is a condition precedent to recovery under the reinsurance agreement; (3) whether, in the absence of condition precedent language, it must be established that the reinsurer suffered prejudice, and which party bears the burden in that regard; and (4) what constitutes prejudice under U.S. law. Each of these issues is separately addressed below.

1. Temporal Notice Requirements

While the effect of a cedent's breach of the notice provision has garnered the most attention from U.S. courts in published decisions, it is axiomatic that the first inquiry in any late notice dispute is whether the cedent failed to notify the reinsurer in a timely fashion as required

by the terms of the reinsurance agreement. To that end, it is necessary to analyze the notice provision of a reinsurance agreement to determine at what point in time a cedent's obligation to notify the reinsurer of a claim is triggered.

The time frame for notice is generally established by reference to a set dollar amount, see e.g. Security Mutual Cas. Co. v. Century Cas. Co., 531 F.2d 974 (10th Cir.), cert. denied 429 U.S. 860 (1976); the accrual of actual losses, see e.g., Continental Cas. Co. v. Stronghold Ins. Co., Ltd., 77 F.3d 16 (2nd Cir. 1996); the time when a claim is likely to involve reinsurance, see e.g. Unigard Sec. Ins. Co. , Inc. v. N. River Ins. Co., 594 N.E.2d 571 (1992), aff'd in part and rev'd in part, 4 F.3d 1049 (2d Cir. 1993) ("Unigard I"); or the time when, in the cedent's judgment, a claim is likely to involve reinsurance. See e.g. Ins. Co. of Pennsylvania v. Associated Int'l Ins. Co., 922 F.2d 516 (9th Cir. 1990). Typically, a cedent is required to provide "prompt notice," "immediate notice," or notice "as soon as practicable" to the reinsurer when its obligation to provide notice has been triggered. In this regard, U.S. courts have concluded that such language requires notice to the reinsurer within a reasonable time after the duty to give notice has arisen. Unigard Sec. Ins. Co., Inc. v. N. River Ins. Co., 4 F.3d 1049, 1065 (2d Cir. 1993) ("Unigard II"); Christiana Gen. Ins. Corp. of N.Y. v. Great American Ins. Co., 979 F.2d 268, 275 (2d Cir. 1992); Folksamerica Reinsurance Co. v. Republic Ins. Co., 2003 U.S. Dist. LEXIS 21584, *48 (S.D.N.Y. Dec. 1, 2003). A reasonable time is measured by an objective evaluation of the facts and circumstances. Christiana, supra, 979 F.2d at 275.

The more critical analysis is when a cedent's duty to give notice is triggered under the terms of the reinsurance agreement. While notice requirements based on set dollar amounts, specific types of claims, actual losses, and other objective criteria do not require much analysis, notice provisions requiring notice when a claim "may" involve reinsurance or "appears likely" to

involve reinsurance are more susceptible to disputes between cedents and reinsurers as to whether a cedent breached the notice provision.

U.S. courts have adopted an objective standard to determine whether a claim "may" or "appears likely" to involve reinsurance for purposes of triggering the cedent's notice obligation. U.S. courts have squarely rejected the proposition that such language requires a "reasonable probability" that the claim will involve reinsurance, and instead have held that "[a]ll that is required is a 'reasonable ***possibility***' of such happening, based on an objective assessment of the information available." Christiana, supra, 979 F.2d at 276 (emphasis added); see also, Liberty Mutual Ins. Co. v. Gibbs, 773 F.2d 15, 17 (3d Cir. 1985); Insurance Co. of Pa. v. Associated Int'l Ins. Co., 922 F.2d 516, 522 (9th Cir. 1990). "Such a possibility may exist even though there are some factors that tend to suggest the opposite." Id. A "theoretical possibility" that a policy will not be involved is not the standard; the objective standard is a "reasonable possibility" that a claim will involve reinsurance. Id.

Based on the foregoing, it is clear that the current trend under U.S. law with respect to the triggering of a cedent's notice obligation favors reinsurers. If the objective criteria triggering notice have been met, or if there is a "reasonable possibility" that a claim will involve reinsurance, U.S. courts require a cedent to notify the reinsurer of the claim or loss within a reasonable period of time. If they fail to do so, the cedent will be deemed to have breached the notice provision of the reinsurance agreement.

2. Breach of Notice Provision – Prejudice Required

Even if a reinsurer can establish that a cedent failed to provide timely notice of a claim, a successful disclaimer of a claim based on late notice is far from certain. The modern trend in U.S. courts disfavors viewing notice as a condition precedent that automatically results in a

forfeiture of reinsurance coverage if breached. Rather, the modern trend in U.S. courts is to require the reinsurer to establish that it has suffered prejudice as a result of the untimely notice before coverage under a reinsurance policy is forfeited. James H. Foster, *Late Notice of Reinsurance Claims*, 29 Tort & Ins. L.J. 773, 774 (1994). This trend is the result of the distinction between reinsurance and direct policies, as well as the overall preference in U.S. courts in favor of coverage.

The most significant and oft-cited decisions in this area of reinsurance law and late notice are Unigard I, supra, 594 N.E.2d at 571, and Unigard II, supra, 4 F.3d at 1049. At issue in those decisions was whether the cedent was obligated to provide notice to its reinsurer regarding a settlement agreement entered into to resolve underlying claims regarding asbestos. The question certified to the New York Court of Appeals in Unigard I was whether "a reinsurer [must] prove prejudice before it can successfully invoke the defense of late notice of loss by the reinsured." Unigard II, 4 F.3d at 1063. The New York Court of Appeals rejected the argument that prejudice should be presumed as a result of the late notice and concluded that a reinsurer must prove prejudice and tangible economic harm to disclaim coverage based on late notice. Unigard I, 594 N.E.2d at 575. This decision was based in large part on the distinction between the relationship of an insured/insurer and a cedent/reinsurer:

> A reinsurer is not responsible for providing a defense, for investigating the claim or for attempting to get control of the claim in order to effect early settlement. Unlike a primary insurer, it may not be held liable to the insured for a breach of these duties. Settlements, as well as the investigation and defense of claims are the sole responsibility of the primary insurer; and settlements made by the primary insurer are, by express terms of the reinsurance certificate, binding on the reinsurer. Thus, failure to give the required prompt notice is of substantially less significance for a reinsurer than for a primary insurer.
>
> Moreover, the interests of a reinsurer and the ceding primary insurer with respect to a pending claim are generally identical. The "follow the fortunes" clause in most reinsurance agreements leaves reinsurers little room to dispute the

> reinsured's conduct of the case. In addition, the interests of both parties are furthered through the primary insurer's efficient investigation and defense of the claim and through the resolution of the claim on the best terms possible [internal citation omitted]. By contrast, the interests of the primary insurer and its insured may often be adverse. There may be disputes over cooperation or coverage or over claimed collusion on the part of the insured. These factors make prompt notice of the claim and expeditious processing and control of it a matter of vital concern to the primary insurer. Such considerations have greatly diminished application to the reinsurer.
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> [Id. at 574-75].

These considerations were also highlighted by the United States Court of Appeals for the Tenth Circuit in Security Mutual, supra, 531 F.2d at 978. As noted by the Security Mutual court, the notice requirement should not be strictly applied to cedents because, unlike insurers who need timely notice to investigate claims and estimate liability, reinsurers rely upon cedents to investigate and defend a claim. Id. Notice protects the right to participate in the defense of the claims, but this right is much more significant for an insurer than a reinsurer. Ibid. Because the parties to a reinsurance contract are both sophisticated, and the relationship provides for the regular exchange of information, a reinsurer generally must demonstrate more than late notice to disclaim coverage. See e.g. Unigard II, supra, 4 F.3d at 1069.

The Unigard I decision was subsequently appealed to the United States Court of Appeals for the Second Circuit where, in Unigard II, the decision was affirmed in part and reversed in part. With respect to the late notice defense, the Unigard II court affirmed the lower court's holding that the duty of utmost good faith between a cedent and reinsurer required "the prompt and full disclosure of material information," but that, in the absence of prejudice, the late notice defense would fail. Unigard II, supra, 4 F.3d at 1069.

The notice-prejudice rule adopted by the courts in Unigard I and Unigard II finds ample support from the decisions of other courts throughout the U.S. Indeed, the large majority of U.S.

courts have adopted the notice-prejudice rule and imposed on the reinsurer the burden of establishing that it suffered actual prejudice as a result of the cedent's failure to provide timely notice of a claim.[1] Christiana, supra, 979 F.2d at 278; British Ins. Co. of Cayman, supra, 335 F.3d at 207-15; Security Mutual, supra, 531 F.2d at 978; Associated Int'l Ins. Co. v. Odyssey Reinsurance Corp., 1997 U.S. App. LEXIS 6386, at *17 (9th Cir. 1997); Insurance Co. of Pa., supra, 922 F.2d at 523; Zenith Ins. Co. v. Employers Ins. of Wausau, 141 F.3d 300, 307-08 (7th Cir. 1998); Newcap Ins. Co. v. Employers Reinsurance Corp., 295 F. Supp. 2d 1229,1241 (D.Kan. 2003); Travelers Inc. v. Cent. Nat'l, 733 F. Supp. 522 (D.C. Conn. 1990); Folksamerica, supra, 2003 U.S. Dist. LEXIS 21584, at *34.

In sum, the modern trend under U.S. law is that, absent express language that timely notice is a condition precedent to recovery, a reinsurer will not be able to assert a successful late notice defense without a showing that it has been prejudiced by the untimely notice. However, the U.S. courts that have addressed this issue have done so under the traditional cedent/reinsurer relationship. As explained above, U.S. courts have rationalized the notice-prejudice rule based on the typical relationship between a commercial insurer and reinsurer. With respect to captive and fronting insurers, no U.S. court has addressed whether the relationship and motivations of the captive/fronting insurer and the reinsurer are such that the notice-prejudice rule should not apply given the issues and dynamics that are not present with commercial insurers. Given the drastic increase in the number of U.S. domiciled captives, it would not be surprising to see in the

[1] The minority view is that the notice provision, even absent condition precedent language, operates as a condition precedent to coverage. For example, in Keehn v. Excess Ins. Co. of America, 129 F.2d 503 (7th Cir. 1942), the United States Court of Appeals for the Seventh Circuit allowed the forfeiture of coverage, despite the absence of explicit language making timely notice a condition precedent. In pertinent part, the Keehn court rejected the need for conditional language because "the failure to give notice deprived defendant [reinsurer] of the right and opportunity to associate with" the cedent in defense of the underlying claims. Keehn, supra, 129 F.2d at 505; see also, Highlands Ins. Co. v. Employers' Surplus Lines Ins. Co., 497 F. Supp. 169 (E. D. La. 1980); Travelers Ins. Co. v. Buffalo Reinsurance Co., 735 F. Supp. 492 (S.D.N.Y. 1990).

near future a reinsurer challenge the notice-prejudice rule with respect to a captive insurer as the cedent.

3. Prejudice As Defined By U.S. Courts

Of course, the question that arises is whether the reinsurer bears the burden of establishing that it has been prejudiced by the late notice, or if the cedent bears the burden of disproving that the reinsurer has suffered prejudice. In this regard, the majority of U.S. courts impose the burden on the reinsurer to establish that it has suffered prejudice as a result of the late notice. See British Ins. Co. of Cayman, supra, 335 F.3d at 214-15; Unigard I, supra, 594 N.E.2d at 584; Unigard II, supra, 4 F.3d at 1069; Insurance Co. of Pa., supra, 922 F.2d at 524; Folksamerica, supra, 2003 U.S. Dist. LEXIS 21584 at *34; cf. Security Ins. Co. of Hartford v. Trustmark Ins. Co., 2002 U.S. Dist. LEXIS 27348, at *17 (D. Conn. Aug. 2, 2002) (minority view that cedent bears the burden of establishing that the reinsurer has not been prejudiced).

With respect to the issue of what constitutes prejudice, reinsurers face a significant burden under U.S. law. The majority of U.S. courts require a reinsurer to establish actual harm caused by the late notice, *i.e.*, tangible economic injury. Unigard II, supra, 4 F.3d at 1069; Folksamerica, supra, 2003 U.S. Dist. LEXIS 21584 at *34. As noted by one U.S. court, the only prejudice sufficient to allow an insurer or reinsurer to avoid liability based on late notice is found where the reinsurer demonstrates "that there was a substantial likelihood that it could have either defeated the underlying claim against its insured, or settled the case for a smaller sum than that for which its insured ultimately settled the claim." Insurance Co. of Pa., supra, 922 F.2d at 524. Yet another U.S. court held that the reinsurer must demonstrate that it would have "associated" in the defense if given proper notice and that the association would have resulted in a more

favorable ruling. Fortress Re, Inc. v. Central Nat'l Ins. Co., 766 F.2d 163, 166-67 (4th Cir. 1985).

In summary, reinsurers face a significant obstacle in disclaiming coverage on the grounds that the cedent failed to provide timely notice of a claim under the terms of the reinsurance agreement. While U.S. courts have consistently invited reinsurers to establish that they have suffered prejudice, *i.e.*, tangible economic injury, the inescapable reality is that a reinsurer is at a significant disadvantage since it must establish how its actions would have limited its exposure under the reinsurance agreement had it received proper notification from the cedent. Clearly, such an exercise in "second-guessing" the cedent is frowned upon and runs counter to the follow-the-fortunes clause typically included in reinsurance agreements.

4. Notice As A Condition Precedent

While the majority of U.S. courts require that a reinsurer establish prejudice as a result of a cedent's late notice in order to avoid its obligations under the reinsurance agreement, U.S. courts also recognize an exception to the notice-prejudice rule. Generally, claims cooperation and notice clauses will be considered an obligation rather than a condition precedent. Unigard II, supra, 4 F.3d at 1049. As such, and as discussed above, U.S. courts have required reinsurers to establish prejudice as a result of a cedent's untimely notice of claims.

Significantly, however, where the claims cooperation clause or notice provision expressly states that compliance is a "condition precedent" to recovery under the reinsurance agreement, U.S. courts have willingly abandoned the prejudice requirement and permitted reinsurers to disclaim coverage without the necessity of establishing prejudice. For example, in Gibbs, supra, 773 F.2d at 15, the United States Court of Appeals for the First Circuit addressed whether late notice must prejudice the reinsurer in order to disclaim coverage. Gibbs involved a reinsurance

policy wherein the notice provision indicated that timely notice was a condition precedent to any liability under the policy. Id. at 16. The Gibbs court, based upon the explicit language in the provision, found that as long as there was a reasonable possibility of a claim, the failure to notify the reinsurer amounted to late notice. Id. at 17-19. More importantly, the Gibbs court went on to hold that the reinsurer did not have to establish prejudice as a result of the late notice because notice was a condition precedent to coverage under the reinsurance agreement. Id. at 18-19.

Subsequent U.S. courts have likewise given effect to express provisions in a reinsurance agreement that require prompt notice as a condition precedent. See Constitution Reinsurance Co. v. Stonewall Ins. Co., 980 F. Supp. 124, 130-31 (S.D.N.Y. 1997). Other courts have, in dicta, approved the rule whereby a reinsurer need not show prejudice if the notice provision is specifically stated as a condition precedent to recovery under the reinsurance agreement. See Christiana, supra, 979 F.2d at 274; Unigard I, supra, 594 N.E.2d at 574. However, in general, "a provision for notice will not be construed as a condition precedent unless that intention is clearly and unequivocally stated in the contract." Security Mutual, supra, 531 F.2d at 976.

Thus, while U.S. courts impose the harsh notice-prejudice rule on reinsurers in the absence of condition precedent language, they offer reinsurers a bit of relief if the contractual language of the reinsurance agreement expressly dictates that compliance with the notice requirements is a condition precedent to recovery. As a result, any late notice defense by a reinsurer under U.S. law must include the preliminary determination as to whether timely notice is a condition precedent to recovery by the cedent.

C. THE CLAIMS COOPERATION CLAUSE AND THE RIGHT TO ASSOCIATE

Although reinsurers have historically opted not to exercise their contractual right to associate with the cedent in the defense or control of claims, the emergence of new and

undeveloped markets exposing reinsurers to risk, as well as the increased use of captive insurance companies and fronting insurance companies, suggests that reinsurers may, under certain circumstances, benefit from participation in the defense and control of claims. Of course, the right to associate is intertwined with a cedent's obligation to cooperate. To that end, claims cooperation clauses typically include language entitling a reinsurer to associate with the defense or control of a claim.[2]

U.S. courts addressing the right to associate provision within a claims cooperation clause, or standing alone, have done so in the context of a late notice dispute. As demonstrated below, U.S. courts' view of a reinsurer's right to associate has been less than favorable. In fact, U.S. courts have refused to acknowledge that a reinsurer's loss of the right to associate, in and of itself, constitutes prejudice to the reinsurer.

In Unigard I, the court squarely addressed the consequences of a reinsurer's loss of the right to associate due to the cedent's failure to provide timely notice of a claim. While recognizing that the right to associate clause involves a reinsurer's right to consult with and advise the cedent in its handling of the claim, the Unigard I court refused to hold that the loss of such a right warrants a presumption of prejudice. Unigard I, supra, 594 N.E.2d at 575. In so holding, the Unigard I court stated:

> We agree that there are cases in which the reinsurer's right to associate may be impaired by late notice from the reinsured. Nonetheless, because of the critical distinction between a primary insurer's right to control the investigation and defense of a claim and a reinsurer's "right of association" with the ceding companies, we cannot agree with Unigard's contention that the risk of such impairment is sufficiently grave to warrant applying a presumption of prejudice. Accordingly, there is no sound reason to depart from the general contract law principle that a breach will excuse performance only if it is material or demonstrably prejudicial.

[2] A right to associate provision may also be a separate clause within a reinsurance agreement.

> Indeed, it has been noted that reinsurers seldom have occasion to exercise their right to associate.

[Id. (internal citations omitted)].

The Court of Appeals for the Third Circuit similarly rejected the argument that a reinsurer's loss of the right to associate results in a presumption of prejudice. British Ins. Co. of Cayman, supra, 335 F.3d at 214. In so ruling, the Third Circuit expressly noted that "reinsurers rarely exercise their right to associate." Id. (citing 14 *Appleman on Insurance: Law of Reinsurance*, § 105.7 at 384 (2d ed. 2000)("[A]lthough reinsurance contracts commonly reserve the reinsurer's right to associate with the ceding insurer in the defense or control of claims involving the reinsurance, reinsurers rarely involve themselves in the defense or investigation of the underlying claims.")). The Third Circuit also rationalized its decision based on its opinion that "the primary exposure of the reinsured gives it as much, if not more, reason to ensure that a claim is properly investigated and defended." Id.

Other courts have similarly placed the burden on the reinsurer to establish that its loss of the right to associate resulted in prejudice. See Insurance Co. of Ireland Ltd. v. Mead Reinsurance Corp., 1994 U.S. Dist. LEXIS 15690, at *17-25 (S.D.N.Y. 1994); Christiana, supra, 979 F.2d at 274 (the primary functions of prompt notice to a reinsurer are to enable it to set proper reserves, to allow it to decide whether it wants to participate in the defense of a certain claim, and to permit it to establish premiums that accurately reflect past loss experience); Fortress Re, supra, 766 F.2d at 166 (whether prejudice would result from the loss of the ability to participate in the defense and control of the claim and its evaluation for settlement purposes is an issue of material fact). As stated by the Insurance Co. of Ireland court, "[a]lthough it will be difficult for the reinsurers to establish that they were actually harmed by the foreclosure of their opportunity to assist ICI in the presettlement negotiations, their task is not impossible, and they

must be allowed a chance to convince the trier of fact that there was prejudice." Insurance Co. of Ireland, supra, 1994 U.S. Dist. LEXIS 15690 at *24.

In light of the foregoing, it is clear that the trend amongst U.S. courts is to require a reinsurer to establish that it has suffered prejudice as a result of the loss of the right to associate in the defense or control of the underlying claim. In essence, reinsurers are required to establish that their participation in the defense of the claim or control of the claim would have resulted in a more favorable outcome. Given that significant burden, reinsurers must consider the benefits of associating with the defense for claims that have the potential for a questionable settlement or loss. The potential for a questionable settlement or loss is particularly present when a captive insurance company or fronting insurance company is the cedent.

It is important to note, however, that none of the above-cited cases involved a captive or fronting insurer as the cedent. While it is true that in the traditional cedent/reinsurer relationship reinsurers rarely invoke their right to associate, the growing captive insurer and fronting insurer trend in the U.S. alters the reinsurance landscape. Reinsurers may be more inclined to participate in the defense of a claim when the cedent is a captive or fronting insurance company. Thus, while the current state of U.S. law affords little weight to a reinsurer's right to associate, we suspect that U.S. courts may revisit their view of the issue when presented with a matter involving a captive or fronting insurer.

With respect to a captive insurance company, the danger is that the insured/parent company will control the handling of the claim(s) and make decisions based on business considerations that otherwise would not be made if insured by a commercial insurer. There is also the concern that the captive insurance company will not diligently pursue coverage defenses and other coverage related issues since it is controlled by the insured. Similarly, the risks

inherent with fronting companies are that they can be perceived to lack incentive to aggressively defend claims and pursue coverage defenses since they retain little or no financial risk.

While there remain practical reasons for reinsurers to avoid undertaking control of underlying claims (increased costs, potential forfeiture of valid coverage defenses under reinsurance agreement, exposure to bad faith, and potential for cut-throughs), reinsurers are now faced with market trends (captive insurers and fronting insurers) that warrant consideration by reinsurers to become involved in the defense of a claim to protect against questionable claims handling, settlements and losses for which they may bear the ultimate financial responsibility. The alternative is that reinsurers face a difficult task after the fact to challenge the settlement or loss based on U.S. courts' interpretation of the follow-the-fortunes clause in favor of the cedent.

D. ACCESS TO CLAIM INFORMATION UNDER THE CLAIMS COOPERATION CLAUSE AND ACCESS TO RECORDS PROVISIONS

A cedent's obligations to cooperate with the reinsurer are not limited to providing timely notice and affording the reinsurer the right to associate. A cedent's obligation to cooperate is more commonly associated with the production of information and documents related to underlying claims. Because the cedent is in a better position than the reinsurer to have the necessary information to evaluate underlying claims, the free exchange of information between the cedent and reinsurer is an essential element of reinsurance agreements that is intended to protect the reinsurer. Without full disclosure of information and documents pertaining to the underlying claim by the cedent, a reinsurer is at a disadvantage in that it is unable to accurately assess the claim, the coverage issues presented, and its own obligations under the reinsurance agreement.

The importance of a cedent's disclosure of claim information and documents can be heightened when the cedent is either a captive insurance company or fronting insurer. In the

case of a captive insurance company, reinsurers must be aware that the captive insurance company may withhold certain information and documents at the request of the insured/parent company. For example, the reasons for non-disclosure could include the adoption of a claims-handling/litigation strategy by the insured/parent company that is premised on business considerations, as opposed to a strategy designed to minimize liability and damages exposure. With respect to fronting insurers, the non-disclosure of information and documents could result from the fronting insurer's passive approach to a claim or claims given that it retains little to no risk. Under either scenario, a reinsurer must be mindful of its rights to receive a cedent's cooperation through the production of information and documents pertaining to underlying claims. Indeed, the claims cooperation clause and access to records provisions, also known as an audit or inspection clause, mandate such disclosure by the cedent. Those clauses entitle reinsurers "to ensure the accuracy of the insurer's loss reserves, to identify the unreported losses, and to assess the skills and experience of the insurer's underwriters and claims personnel as well as managers." Robert W. Strain, *Reinsurance Contract Wording* 42 (3d Ed. 1998).

The breadth of the cedent's duty to disclose documents to the reinsurer cannot be overstated. Under U.S. law, a cedent is obligated to provide the reinsurer "with **all** documents or information in its possession that **may be** relevant to the underlying claim adjustment and coverage determination." North River Ins. Co. v. Philadelphia Reinsurance Corp., 797 F. Supp. 363, 369 (D.N.J. 1992), aff'd in part and rev'd in part on other grounds sub nom. North River Ins. Co. v. CIGNA Reinsurance Co., 52 F.3d 1194 (3d Cir. 1995) (emphasis added). In fact, claims cooperation and access to records provisions are, in many ways, codifications of the implicit duty of utmost good faith owed between cedents and reinsurers. See Christiana, supra, 979 F.2d at 278; Eugene Woollan, *Handbook of Reinsurance Law* §5.05 (2003). U.S. courts

have, therefore, explicitly recognized a cedent's obligation to cooperate with the reinsurer by disclosing all information and documents relevant to the underlying claim adjustment and coverage determination.

Despite the importance of information and document exchange under reinsurance agreements, disclosure of such information and documents is not always forthcoming. Because the claims cooperation and access to records clauses require disclosure of information from the cedent regarding its accounting and claims handling, the fulfillment of this obligation necessarily implicates privileged documents. In fact, as a practical matter, the documents that are most significant to reinsurers generally contain privileged information. Cedents, though willing to disclose non-privileged materials, are typically unwilling to disclose privileged documents. The concerns of the cedent are grounded not only in the potential waiver of the privilege, but also in the possibility of arming the reinsurer with information that could be used by the reinsurer to disclaim any obligation under the reinsurance agreement. Hence, the pivotal question is whether a reinsurer's right to obtain claim documents and information in the cedent's possession permits unbridled access to the cedent's records, notwithstanding privilege issues.

This question was squarely before the court in North River, supra, 797 F. Supp. at 363. The reinsurer in North River contended that the cedent waived its attorney-client privilege with respect to documents related to the underlying claim by agreeing to include the claims cooperation clause in the reinsurance policy. Id. at 368. Disagreeing with the reinsurer's argument, the North River court held as follows:

> Although a reinsured may contractually be bound to provide its reinsurer with all documents or information in its possession that may be relevant to the underlying claim adjustment and coverage determination, absent more explicit language, it does not through a cooperation clause give up wholesale its right to preserve the confidentiality of any consultation it may have with its attorney concerning the underlying claim and its coverage determination.

[Id. at 369].

The North River court found that, as long as the cedent has disclosed all documentation relevant to the underlying claim that was not privileged, it satisfied its obligations under the claims cooperation clause. Ibid.

Like the North River court, U.S. courts have universally held that claims cooperation and access to records clauses do not permit a reinsurer to pierce a cedent's privileges. U.S. courts have consistently concluded that these clauses permit access to the cedent's books, claims and underwriting files before and in conjunction with the defense and/or settlement of claims, but do not afford fishing expeditions whereby the reinsurer can access the cedent's records at any time and pierce any privileges. See North River, supra, 797 F. Supp. at 363; In re Arbitration of Int'l Surplus Lines Ins. Co. v. People's Ins. Co. of China, 1994 U.S. Dist. LEXIS 12929 (N.D. Ill. Sept. 12, 1994); Remington Arms Co. v. Liberty Mut. Ins. Co., 142 F.R.D. 408, 417 (D. Del. 1992) (the claims cooperation clause "does not imply a duty to produce documents protected by the attorney-client privilege"); Bituminous Cas. Corp. v. Tonka Corp., 140 F.R.D. 381, 386 (D. Minn. 1992), aff'd 9 F.3d 51 (8th Cir. 1993); Gulf Ins. Co. v. Transatlantic Reinsurance Co., 788 N.Y.S.2d 44, 46 (1st Dep't 2004) (finding the clause does not create an automatic waiver of privilege); U.S. Fire Ins. Co. v. Phoenix Assur. Co., Index No. 7712/91 (N.Y. Sup. Ct. Aug. 18, 1992), aff'd 598 N.Y.S.2d 938 (1993) (the court concluded that merely because the cedent shared privileged documents in the past when the parties shared a common interest does not waive the right to assert privilege when a coverage dispute arises); Metropolitan Life Insurance Co. v. Aetna Casualty and Surety Co., 249 Conn. 36, 55 n. 20 (Conn. 1999); Eastern Air Lines, Inc. v. U.S. Aviation Underwriters, Inc., 716 So.2d 340, 343 n.3 (3d Dist. Fla. App. 1998); Rockwell Int'l Corp. v. Superior Court, 26 Cal. App. 4th 1255 (Cal. Dist. Ct. App. 1994);

Owens-Corning Fiberglas Corp. v. Allstate Ins. Co., 74 Ohio Misc. 2d 174 (1993); Kimberly-Clark Corp. v. Continental Cas. Co., 2006 U.S. Dist. LEXIS 63576 (N.D. Tex. Aug. 18, 2006). These clauses do not act as a waiver of the cedent's privileged communications. See North River, supra, 797 F. Supp. at 367-69. But see Waste Management, Inc. v. Int'l Surplus Lines Ins. Co., 144 Ill.2d 178, 192-93 (1991). As a result, under existing U.S. law, a cedent's duty to disclose will likely not expand to permit a reinsurer access to documents containing privileged information under the attorney-client and work product privileges.

While a cedent can rely on U.S. law to withhold privileged information and documents, reinsurers can attempt to persuade the cedent that the common interest doctrine, also known as the "community of interest doctrine" or the "joint defense privilege," protects the privileged nature of the information or documents when exchanged between a cedent and reinsurer. In general, the common interest doctrine protects the attorney-client privilege and work product privilege where the parties share a common legal interest and cooperate toward a common legal goal. See generally, DuPlan Corp. v. Deering Milliken, Inc., 397 F. Supp. 1146, 1172 (D.S.C. 1975). Notably, U.S. courts generally have held that the reinsurer/cedent relationship alone is not enough to invoke the common interest privilege. North River Ins. Co. v. Columbia Cas. Co., 1995 WL 5792 at *1, *3 (S.D.N.Y. Jan. 5, 1995). Traditionally, the cedent and reinsurer have a common interest in the proper handling of claims "to avoid groundless claims . . . [and address and anticipate] current and potential exposure." Torch, supra, 3 Pierce L. Rev. at 348. However, common interests oftentimes vanish because a reinsurer cannot demonstrate commonality in the outcome of the particular underlying litigation. See e.g. International Ins. Co. v. Newmont Mining Corp., 800 F. Supp. 1195 (S.D.N.Y. 1992); North River, supra, 797 F. Supp. at 367; DuPlan, supra, 397 F. Supp. at 1172. Whether the particular facts justify invocation of the

common interest doctrine for the exchange of privileged information and documents between a cedent and reinsurer must be analyzed on a fact-sensitive basis and take into account the law of the particular jurisdiction involved.

In summary, U.S. courts have recognized a reinsurer's right to obtain all information and documents from the cedent pertaining to the underlying claim. However, U.S. courts have generally protected a cedent's right to withhold from production privileged information and documents held by the cedent that commonly contain the information that is critical to a reinsurer's analysis of the claim. These issues are also prevalent with respect to the relationship between reinsurers and captive insurers and fronting insurers. As reinsurers attempt to gather information and documents pertaining to claims, it is quite likely that captive insurers and fronting insurers will rely on privilege concerns to withhold from production information necessary for reinsurers to fully evaluate the underlying claim and the handling of the claim. It is, therefore, necessary for reinsurers to actively pursue the captive insurer's and fronting insurer's production of relevant information and documents, and, when necessary, consider their legal options with respect to forcing captive insurers and fronting insurers to produce privileged documents.

E. CONCLUSION

The fast-growing trend of the use of captive insurance companies and fronting insurance companies to insure U.S.-based risks potentially presents practical and legal issues for reinsurers in terms of obtaining timely notice and cooperation. Since captive insurers and fronting insurers represent a departure from the "traditional" cedent/reinsurer relationship, concerns regarding the handling of claims and motivations underlying settlements may be more prevalent. As a result, reinsurers must remain mindful of their right to timely notice, right to associate in the defense,

and right to cooperation from the cedent, and how U.S. courts enforce these rights. While not every reinsurance claim tendered by a captive insurer or fronting insurer raises such concerns, reinsurers will surely be faced with more claims cooperation issues as the captive insurer and fronting insurer trend continues to grow in the U.S.