The 2013 Captive Quandary And The Duty Of Utmost Good Faith

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[Editor’s Note: Adam H. Fleischer and Jason P. Minkin are partners with Bates Carey Nicolaides LLP in Chicago and practice in the areas of insurance and reinsurance litigation. This article is an update of an article that first appeared on Nov. 11, 2004, in Mealey’s Litigation Report: Reinsurance Vol. 15, No. 14. Copyright © 2013 by Adam H. Fleischer and Jason P. Minkin. Responses are welcome.]

I. Introduction

Today more than ever, reinsurers are reinsuring either captive insurance companies or reinsureds who retain only a very small share of the risk for themselves, while passing most of the risk to reinsurers.1 When a loss occurs under such a scenario, reinsurers are often contractually relegated to sitting helplessly on the sideline and watching the claim being managed by a reinsured who really does not have much of its own money on the line, and who has very little incentive to mount a comprehensive, time consuming, and costly coverage defense and investigation. In these instances, the single greatest weapon protecting the reinsurer is the duty of utmost good faith or uberrima fides.2 A reinsured’s failure to fulfill these obligations may be fatal to its reinsurance claim. The reinsurer’s right to expect utmost good faith from the reinsured, even from a captive reinsured, during the claims handling process, is the focus of this article.

II. Understanding The Duty Of Utmost Good Faith

Reinsurance is premised upon a fundamental quid pro quo: as reinsurers are deprived of some rights by doctrines such as “follow the fortunes,” they are to get other rights in return through doctrines such as the duty of utmost good faith. Here is how it works:

When a reinsurer agrees to reinsure part of a risk, that reinsurer is typically deprived of any significant control over claims management, and therefore the reinsurer sacrifices the ability to protect its money on the risk. However, in return, the reinsurer receives the reciprocal protections and legal guarantees that the reinsured will actively protect the risk and the reinsurer’s interests as if they were the reinsured’s own. The symbiotic relationship between “follow the fortunes” and utmost good faith is discussed below.

A. Follow The Fortunes: Why The Reinsurer Needs The Duty Of Utmost Good Faith

“Reinsurance works only if the sums of the reinsurance premiums are less than the original insurance premium . . . For the reinsurance premium to be less, reinsurers cannot duplicate the costly but necessary efforts
of the primary insurer in evaluating risks and handling claims. Reinsurers may thus not have actuarial expertise, or actively participate in defending claims."3 Insurers agree that a ceding company, which is closer to the direct insured, makes the investigation, and is in possession of all the details relating to the risk, is required to exercise the utmost good faith in all its dealings with the reinsurer.4

So, the typical reinsurance relationship assumes that the reinsurer will likely not be in the driver’s seat when it comes to managing claims. Although the reinsurer usually does not have the right to manage claims, the reinsurer does usually have the contractual “right to associate.” This right to associate is a right that, in most cases, leaves the reinsurer in the back seat, yelling out suggested directions to the reinsured, but ultimately it is the reinsured who decides how fast to drive the claim, how far, when to turn the wheel, which route to take, and when to hit the brakes. The reinsurer is almost quite literally along for the ride. Like many back-seat drivers, the reinsurer may frequently find itself not in complete agreement with its reinsured as to the selection of counsel, the selection of forum for litigating an underlying claim, the legal conclusions regarding the validity of certain coverage defenses and, of course, the settlement value of the claim at issue.

To make matters worse for the reinsurer, the law often prevents the reinsurer from second-guessing the results of most claims handling decisions made by the reinsured. This is called the “follow the fortunes” or sometimes the “follow the settlements” doctrine.5 Under the “follow the fortunes” doctrine, reinsurers are obligated to follow the reinsured’s decisions with respect to an underlying policyholder’s direct insurance claim when those decisions are reasonable and made in good faith.6 Most reinsurance contracts contain a “follow the fortunes” clause that is the source of this doctrine. It is still an open question as to whether the “follow the fortunes” doctrine applies in the absence of such a clause in the reinsurance contract.7

Under the “follow the fortunes” doctrine, courts have found that a reinsurer may not deny payment on the grounds that a ceding company “should have attempted” to enforce certain exclusions in the ceding company’s direct policies, or that the ceding company should have negotiated a better settlement with the policyholder.8 Similarly, courts hold that a reinsurer may not deny a reinsurance cession based on an interpretation of the ceding company’s direct policies of insurance that is inconsistent with the reasonable, good faith interpretation that the ceding company itself placed on those policies.9

After a large verdict against the insured or after a sudden settlement, the “follow the fortunes” doctrine often leaves the reinsurer essentially eating a meal of crow that it had very little role in catching or cooking. Standing on its own, the “follow the fortunes” doctrine leaves the reinsurer wide open to collusion between the underlying claimant and the reinsured, and the reinsurer is largely stuck with the result. This possibility is an especially real threat for the reinsurer in a scenario where the reinsured is a captive or other cedent who has retained very little risk for itself. To guard against the countless suspicious circumstances that may arise from such a scenario, for every degree of control taken away from the reinsurer by the “follow the fortunes” doctrine, a degree of protection must be put in place by the duty of utmost good faith. The duty of utmost good faith allows a reinsurer to challenge the good faith manner in which the reinsured handled, settled or allocated damages in a claim.

While there is no single case that reconciles the symbiotic relationship between these two legal ideas, it is not difficult to do so. Essentially, the “follow the fortunes” doctrine exists to prevent a reinsurer from challenging the results or conclusions of the reinsured’s good faith claims handling. On the other hand, the duty of utmost good faith allows the reinsurer to challenge the claims handling process itself undertaken by the reinsured.10 If the process itself was not performed with the utmost good faith, then the reinsurer has a strong argument to deny coverage without directly challenging the reinsured’s conclusions. The manner in which the claims handling process is permeated by the duty of utmost good faith is addressed below.

B. The Duty Of Utmost Good Faith In Claims Handling
The duty of utmost good faith is implied in all reinsurance contracts. Historically, the very nature of reinsurance mandated that the parties’ contractual relations must be based on a duty of utmost good faith.11 Utmost good faith contracts have been described as “so delicate in character and so susceptible of abuse that unusual precautions must be observed by both parties in their
implementation.” Those “unusual precautions,” if properly carried out, are what may later justify sticking the reinsurer with the old “follow the fortunes” doctrine. Unfortunately, there is no single case that describes what “unusual precautions” a reinsured must take during the claims handling process pursuant to its duty to utmost good faith. However, a sharp picture of these precautions can be painted through a survey of applicable law.

1. Duty To Report Claim Developments
The obligation of the reinsured to report all material facts to its reinsurer is most often discussed in terms of underwriting information the reinsured must provide at the time of contract formation. In these instances, if the reinsured even innocently fails to report material facts to the reinsurer, then the duty of utmost good faith has been breached and the reinsurance contract is voidable. The purpose of requiring the disclosure of all material facts to the reinsurer is to provide the reinsurer enough information to be in the same position as the reinsured in terms of judging the risk.

Just as a reinsurer has the right to be put in the same position as the reinsured to judge a risk at the time of contract formation, this reasoning also dictates that a reinsurer must have the same right to independently judge a claim as the claim develops. Courts have acknowledged that the duty of utmost good faith continues after the contract is formed and throughout the reinsurance relationship. Therefore, just as the reinsurer requires all material facts to judge a risk at the time of contract formation, the reinsurer also requires all material facts to evaluate a claim as it evolves. In other words, the duty to disclose facts material to a reinsurer’s risk does not end at contract formation. The flow of claims updates is important information that allows a reinsurer to exercise its right of association, to set its own reserves, and even to make decisions on accepting future risks.

Therefore, as part of the reinsured’s duty of utmost good faith, it is essential that the reinsured inform the reinsurer of any material factual developments in the evolution of pending claims. As one commentator wrote:

The cedent must exercise “utmost good faith” in all of its dealings with a reinsurer. This demands that the cedent supply information of requisite quantity and quality to enable the reinsurer to fully and properly assess the risk. The reinsurer should be placed in a position where it has risk assessment capability equal to that of the ceding company. Importantly, the reinsurer’s information regarding the risks extends to both underwriting and claims information.

It is not enough for the reinsured to report the claim to the reinsurer and then, once the claim is settled, simply send the reinsurer a request for indemnity. In between those points, the reinsured has an obligation to also provide the reinsurer any updates that may materially impact the reinsurer’s evaluation of the risk.

2. Reinsured’s Duty To Responsibly Investigate A Claim
Hand in hand with the reinsured’s duty to report material information is the reinsured’s duty to investigate a claim. A reinsured may not avoid its reporting duties to its reinsurers by willfully sticking its head in the sand and failing to investigate a claim. Quite to the contrary, the reinsured is required by the duty of utmost good faith to actually undertake a proper investigation of claims if it hopes to reap reinsurance indemnity for those claims.

In Suter v. General Accident Ins. Co. of America, Civ. No. 01-2686 (WGB), 2006 U.S. Dist. LEXIS 48209 (D.N.J. July 14, 2006), the reinsured paid numerous claims involving defective heart valves based on the underlying insured’s representation that the law supported a “date-of-implant” trigger. Had the reinsured investigated this, the reinsured would have discovered that the law supported an “injury-in-fact” trigger, which would have moved the claims into much later years in which the reinsurer was not on the risk. In the subsequent reinsurance litigation, the court found that the reinsured’s perfunctory investigation was not proper and business-like, was grossly negligent, and was a breach of the duty of utmost good faith owed to the reinsurer.

A reinsured’s duty and obligations to responsibly investigate a claim can also be derived from case law through negative implication of some late notice cases. For example, in British Ins. Co. of Cayman v. Safety Nat. Cas. Corp., 335 F.3d 205 (3d Cir. 2003), the reinsurer argued that it need not indemnify the reinsured because the reinsured was years late in providing notice of the claim. The reinsurer argued that the reinsured was not relieved of its duty to indemnify because the reinsurer
did not prove that it was prejudiced by the late notice. The Third Circuit held that, “since a reinsurer is not obligated to investigate, litigate, settle or defend claims, the failure to give the required prompt notice is of substantially less significance for a reinsurer than for a primary insurer.” While courts are not too bothered when the reinsurer receives late notice of claims, the underlying reasoning is that the reinsurer has a right to expect that the reinsured has honored its obligation to properly investigate and defend claims on the reinsurer’s behalf.

A challenge to the reinsured’s proper investigation of the underlying claims also arose in the 2012 decision of a New York federal court in Granite State Ins. Co. v. Clearwater Ins. Co., Civ. No. 09-10607, 2012 U.S. Dist. LEXIS 61150 (S.D.N.Y. April 30, 2012). In that manner, the court held that a reinsurer was entitled to discovery of the reinsured’s reserving and analysis of the underlying claims, including any consultant reports, in order to pursue the reinsurer’s defense that the reinsured “failed to implement reasonable and adequate practices and procedures to ensure the proper reporting to [the reinsurer] of notice and related claim information.” The reliance of the reinsurer on the reinsured’s duty of utmost good faith is so integral to the reinsurance marketplace that the reinsured’s good faith duty to investigate still exists even where the reinsured and reinsurer may not have the “generally identical” interests. This is discussed in Section III, below.

3. Reinsured’s Duty To Advocate Coverage Defenses

Not only must a reinsured investigate facts and report its findings to its reinsurer, but the reinsured must also advocate all proper coverage defenses based upon these facts. In order to truly protect the reinsurer’s interest with utmost good faith, it is obviously not enough for the reinsured to report facts to the reinsurer. The reinsured must conduct a proper coverage analysis, properly reserve its rights to advocate certain defenses, and reasonably follow the timely advice of coverage counsel in undertaking these responsibilities.

In examining whether the reinsured properly advocated coverage defenses, there is admittedly a fine line between follow the fortunes and the duty of utmost good faith. While a reinsurer is not likely permitted to challenge the reasonable legal conclusions of its reinsured’s coverage analysis or reservation of rights, the reinsurer certainly has a valid bone to pick if there was no coverage opinion formulated in the first place and no reservations of rights letter. In one Ninth Circuit case, National Amer-

ican Ins. Co. of America v. Certain Underwriters at Lloyd’s of London, 93 F.3d 529 (9th Cir. 1996), the reinsured’s expert testified that, where coverage under the primary policy is disputed, as long as the cedent hires coverage counsel and follows its advice, the reinsured has satisfied the good faith requirement. This may seem like a fairly low threshold for the reinsured to satisfy, however, when the reinsured is a captive, it is too often the case that no reasonable coverage opinion is obtained when the claim is first tendered (as opposed to a post-hoc rationalization after the fact), and no coverage defenses are properly articulated, investigated, or reserved in a reservation of rights letter. Instead, the reinsured often simply sits idly by and drifts in whatever direction the insured may blow. This is fundamentally contrary to the duty of utmost good faith owed to the reinsurer.

In Nationwide Mut. Ins. Co. v. American Re-Insurance Co., 796 F. Supp. 275 (S.D. Ohio 1991) (applying Florida law), the direct insurance policy excluded any liability arising out of employment agency errors and omissions. The reinsured was tendered an underlying claim arising from allegations that the insured employment agency was negligent in placing a request for an employment engagement. In response to this insurance claim, the reinsured never issued a reservation of rights letter, and it ultimately paid the claim and then sought indemnity from American Re, who reinsured 90 percent of the risk. American Re denied reinsurance indemnity based upon the applicability of the underlying exclusion. The court agreed that the exclusion in the reinsured policy barred coverage and therefore, because the loss should not have been covered, American Re was relieved of its obligation to indemnify its reinsured. Although the court did not discuss the case in the context of the duty of utmost good faith, it is clear that the court did implicitly place upon Nationwide a good faith duty to have properly reserved its rights and to have advocated the proper coverage defenses.

C. Proving Breach Of The Duty Of Utmost Good Faith

There are two important issues that frequently arise when a reinsurer attempts to prove the reinsured has breached the duty of utmost good faith. The first issue is whether the reinsurer must prove some type of fraudulent or bad faith conduct on the part of the reinsured. The second issue is whether the reinsurer must prove it
was prejudiced by the reinsured’s breach of this duty. These issues are often intertwined and infrequently addressed directly by the courts. However, based upon a few important reinsurance cases and the intent of the protections afforded to the reinsurer, it is clear that the reinsurer attempting to prove the reinsured’s breach of the duty of utmost good faith need not prove either prejudice or that the reinsured acted in fraudulent or intentional bad faith.

Some of the leading cases discussing the duty of utmost good faith have created the misconception that the breach of this duty requires some sort of fraudulent conduct or ill will. This misconception has been fueled because these cases repeatedly use the phrase “bad faith” to refer to breach of the duty of utmost good faith. In many legal contexts, the idea of “bad faith” does require nefarious motives, ill will, or fraudulent behavior of some sort. However, this is simply not a requirement for a reinsurer to prove a breach of the duty of utmost good faith.

It is in keeping with the purpose and intent of the duty of utmost good faith that a reinsurer need not prove any ill will or intent behind the breach. In 1895, the Fifth Circuit ruled that a reinsured’s concealment of material information which was only the effect of accident, inadvertence, or mistake is equally fatal to the (reinsurance) contract as if it were designed. This same philosophy was applied almost one hundred years later by the court in Christiana Gen. Ins. Corp. v. Great American Ins. Co., 979 F.2d 268, 279 (2d Cir. 1992), which held that “whether the (reinsured’s) duty to disclose has been breached is not affected by whether the failure is intentional or inadvertent.” Other courts have also followed this ruling by holding that even a reinsured’s innocent failure to disclose a material fact is sufficient to establish a breach of the duty of utmost good faith.

When such a breach of the duty of utmost good faith occurs, even innocently, the reinsurer should be relieved from its contractual obligations without the need to prove prejudice. In Certain Underwriters at Lloyd’s London v. The Home Ins. Co., 783 A.2d 238 (N.H. 2001), the reinsurer argued that the reinsurance risk at issue was not covered because the reinsured did not provide timely notice of the claim. The point that brought this argument beyond a simple late notice case and into the realm of the duty of utmost good faith was the fact that the reinsurer argued that the late notification was caused by the reinsured’s failure to have reasonable and routine practices and procedures in place for determining which reinsurers to notify and when. The New Hampshire Supreme Court, relying on the Second Circuit’s ruling in Unigard Sec. Ins. Co. v. North River Ins. Co., 4 F.3d 1049 (2d Cir. 1993), held that a reinsurer may be relieved from indemnifying its reinsured if it proves that the reinsured’s late notice was caused by gross negligence or recklessness. A reinsured acts in gross negligence or recklessness when it fails to implement practices and controls to ensure proper and timely notice of claims to the reinsurer.

After conducting the search for the reinsured’s proper “practices and controls,” the New Hampshire Supreme Court concluded that the reinsured was a bureaucracy lacking effective communication and continuity among its departments, that it had no process of tracking what claims to report to reinsurers, and that nobody at the reinsured ever read the reinsurance policy, let alone complied with any obligations due under the reinsurance contract. The failure to implement such routine procedures deprived the reinsurer of having the same opportunity to have judged the risk as the reinsured—an integral goal of the duty of utmost good faith. Courts agree that, once a determination has been made that the reinsured breached its duty of utmost good faith, then it is unnecessary for a reinsurer to prove it suffered actual prejudice in order to prevail upon its defense.

The most recent test for establishing a breach of the duty of utmost good faith was addressed in United States Fidelity & Guaranty Co. v. American Re-Insurance Co., 2013 N.Y. Slip Op. 00784, 2013 N.Y. LEXIS 112 (N.Y. Feb. 7, 2013). In that matter, the New York Court of Appeals found that, whether the reinsured’s settlement allocation adhered to “good faith” depends on whether the allocation was “one that the parties to the settlement of the underlying insurance claims might reasonably have arrived at in arm’s length negotiations if the reinsurance did not exist.”

Once it is established that the reinsured did not act in a proper and businesslike manner in handling the underlying claim, the reinsurer need not prove prejudice. If a reinsurer would be forced to prove prejudice in order to prevail on a claim for breach of the duty of utmost good faith, then the reinsurer must essentially demonstrate the negative impact that was caused by the erroneous decisions made by its reinsured. To find that
the reinsurer meets this burden, the court would basically have to ignore the “follow the fortunes” doctrine and open the door to the reinsurer’s second-guessing. On the other hand, if the court were to enforce the “follow the fortunes” doctrine and prevent the reinsurer’s second-guessing, then it would be nearly impossible for a reinsurer to prove how it was prejudiced by the reinsured’s actions. In order to give each of these important theories its proper place in the reinsurance relationship and allow them to peacefully coexist, the only logical conclusion is that a reinsurer need not delve into issues of prejudice after proving a breach of the duty of utmost good faith.

III. Collusion And The Captive

A. The Captive Quandary

A reinsurer usually has confidence that its reinsured will adhere to the duty of utmost good faith in claims handling because “the interest of the direct insurer and reinsurers are broadly the same and it is not imprudent for the reinsurers to put themselves unconditionally in the hands of their reinsured for the settlement of claims which will be passed on to them.” Hill v. Mercantile & Gen. Reinsurance Co. PLC [1996] 1 WLR 1239 (HL). While this reasoning may hold true in most reinsurance transactions, when the reinsured is a captive, the reinsured’s interests in defending and protecting the risk begin to lose their commonality with those interests of the reinsurer. So the question arises, “Is a captive expected to adhere to the duty of Utmost Good Faith?” As discussed below, the answer is unequivocally that the captive does indeed have the same obligations of utmost good faith as would any other insurer.

B. But Are Captives Really Supposed To Be Impartial?

Typically, when a reinsurer accuses a captive of having failed to properly act in utmost good faith to defend a coverage claim, the captive’s initial response is something like, “Oh come on! You knew that our captive was simply made up of the risk management team of the insured! Did you really expect us to act like a real insurance company and challenge the claims of our own parent company?” And the reinsurer’s answer to that outburst should be “… Well, yes.” As various commentators have astutely noted:

When transferring risk to a captive, insureds also transfer claims settlement authority. Thus, accountability in the claims handling and settlement process is no less important to the captive than to any insurer: arguably, it may be more so.27

Another commentator described the perils to a captive if it fails to act independently:

In law, a captive insurer is an insurance company like any other . . . In the event of a claim, both parent and captive must take steps consistent with an arm’s length relationship, at least if they hope to effect a recovery under the captive’s reinsurance

* * *

Even where the reinsurance is clearly intended to be back to back with the original cover, the reinsurers are still perfectly entitled to revisit the question of underlying policy liability, and they frequently do . . . [T]here remains an obligation on the part of the captive, in settling the underlying claim, to do so honestly and in a ‘proper and business-like manner.’ Any captive that agrees [i.e., accepts] its parent’s claims without proper and objective review, or otherwise improperly colludes with the parent in the settlement of claims, will fall foul of this requirement.

* * *

As regards claims handling, the parent and captive would be well advised to remain estranged. The captive’s obligations under the reinsurance may require it to adopt positions which are entirely adverse to that of the parent, and it follows that too much filial familiarity can be a dangerous thing.28

Yet another commentator advised:

Companies that use captive insurance companies as part of their risk management strategy, should always bear in mind that the captive insurance company must behave like a proper insurance
It is not sufficient for the Parent to assume that since the Risk Manager of the Parent is also the president of the Captive, that the knowledge of one officer stands as notification to the other... It is imperative that the Captive insurance company give notice to its reinsurers or retrocessionaires, as the case may be, promptly and in accordance with the claims notification clause. Failure to give prompt notification can result in denial of coverage. If there is a fronting company involved, then the fronting company should now remember that, even if it is 100% reinsured, that it still bears 100% of the risk, and that it too has a duty to deal with the claim in a proper and professional manner.

* * *

A captive insurance company should not assume that if it enters into a settlement agreement with its parent, that the captive’s reinsurers are necessarily bound to pay the amount of the settlement... [T]he reinsurers will want to satisfy themselves... were the reinsurers consulted in relation to the settlement... was there coverage under the insurance contract... did the captive take all reasonable defences, did the captive act in a proper and business-like fashion in the investigation and settlement of the claim?29

There are very good reasons that the duty to handle a claim with the utmost good faith should apply even to a captive who is faced with the insurance claim of its parent company. The first reason is that the reinsurer, still restrained by the limitations of the reinsurance contract, will usually not have the contractual right to roll up its sleeves and get directly involved in controlling the defense of the claim, the settlement, or coverage analysis. The captive, regardless of the amount of risk it has retained, still remains the reinsurer’s only hope of properly challenging the insured on coverage issues and overseeing the claim management. A reinsurer has the right to have its money protected, and the captive owes the reinsurer this obligation:

[T]he captive must act with good faith and in a prudent and business-like manner towards its reinsurers, who will need to be satisfied that the captive is settling claims at arms length from its parent.30

Numerous court decisions demonstrate the independent nature of parent and captive. For example, in UMass Memorial Health Care, Inc. v. Lexington Ins. Co., et al., Civ. No. 09-0041-BLS2, 2010 Mass. Super. LEXIS 312 (Mass. Super. Ct. Oct. 28, 2010), UMass Memorial Healthcare, Inc. (“UMMHC”) obtained primary layer insurance from Commonwealth Professional Assurance Company, Ltd. (“CPAC”), UMMHC’s wholly owned captive insurer. In pursuing coverage litigation against its excess insurers, UMMHC argued that the $2.5 million indemnification it had received from the captive was not really a recovery because CPAC was a wholly-owned subsidiary of UMMHC and UMMHC essentially paid the $2.5 million out of its own pocket. The Massachusetts Superior Court rejected UMMHC’s argument and held that, “[I]ndemnity from [the captive] has the same status, for purposes of the [excess policy], as would indemnity from any other underlying (or primary) policy.”

Just over one month later, in Lemos v. Electrolux North America, Inc., 937 N.E.2d 984 (Mass. Ct. App. 2010), the Massachusetts Court of Appeals affirmed that captive insurers enjoy independence from their parents. In Lemos, a captive insurer for Electrolux North America, Inc. argued that the underlying plaintiff could not bring a claim directly against the captive for unfair claims handling because the captive was not really “in the business of insurance,” as required for the claims handling statute to apply. The court held that the captive was an insurer like any other and that the captive as “a distinct corporation issuing documents that have all the indicia of insurance policies” was in the business of insurance and subject to the unfair trade practices statute.

In fact, there are many examples of captive insurers demonstrating the ultimate in arms-length operation, and engaging in coverage litigation against their parent corporations. In Blue Cross Blue Shield of Massachusetts, Inc. v. BCS Ins. Co., 671 F.3d 635, 636 (7th Cir. 2011), the Seventh Circuit resolved a dispute between Blue
Shield insurers and their captive errors-and-omissions insurer regarding the captive insurer’s attempt to deconsolidate an arbitration between Blue Shield and BCS. In Huntsman Corp. v. International Risk Ins. Co., Civil Action No. H-08-1542, 2008 U.S. Dist. LEXIS 74397, *40 (S.D. Tex. Sept. 26, 2008), the court noted that a captive and its parent are not “so closely related as to eliminate their separate identities for purposes of their ability to bring actions against each other.” In Robertson Stephens, Inc. v. Chubb Corp., 473 F. Supp. 2d 265, 279-80 (D.R.I. 2007), a court recognized the independence of a captive from its parent in acknowledging that the parent may assert claims of breach of contract and bad faith against its captive. In In Re The Bennett Funding Group, Inc., 60 Fed. Appx. 863, 866 (2d Cir. 2003), the court held that investors of a bankrupt corporation were not entitled to the proceeds of its captive’s reinsurance policy. The court soundly rejected the argument that, “when a reinsurance contract involves captive insurance companies or fronting companies, it becomes an insurance contract or the separate policies collapse into one.”

As compared to a captive insurer, the reinsurer is still further removed from knowledge of underlying claim developments, the reinsurer still does not have the strong contractual rights to control the underlying claim, and the reinsurer is therefore still entitled to rely upon its reinsured to help perform these duties on its behalf. So, one reason the captive must adhere to the duty of utmost good faith is because the captive is often the reinsurer’s only hope to properly protect the reinsurance risk.

A second reason that captives can reasonably be expected to act like a true independent insurance company is because that is exactly how they intend to be viewed for tax purposes. Generally, the parent corporation would like for the premiums it pays to the captive to be deductible as an ordinary and necessary business expense. In order to gain this benefit, as well as tax benefits for the captive itself, captive insurers have gone toe to toe with the IRS to convince it that a captive insurer should be treated like any other insurance company, and not simply seen as self-insurance for its parent.31

Of course, if captives demand to be treated as an arms length insurer in order to gain tax benefits, then captives should also act like an arms length insurer for purposes of claims handling. This includes investigating claims, reporting to its reinsurers, and advocating all applicable coverage defenses with the utmost good faith.

IV. Conclusion
A reinsured’s duty of utmost good faith owed to its reinsurer is the foundation upon which the reinsurance relationship is built. This duty should guarantee that the reinsured, no matter how little risk is retained, operates at arms length from the insured in investigating claims, advocating coverage defenses, reporting to the reinsurer, and evaluating liability. Generally, the reinsurer is contractually prohibited from undertaking these tasks itself, which increases the importance of the reinsured’s performance of the claims handling process with a high degree of integrity and transparency. In the event this process breaks down, the reinsurer’s risk is left essentially unprotected. Therefore, the duty of utmost good faith serves as both the shield and the sword, protecting the interests of reinsurers and defining the claims handling responsibilities of reinsureds, including captives.

Endnotes

1. In 2012 A.M. Best estimated that there were more than 5,000 captives worldwide. While Bermuda, the Cayman Islands, Barbados and Guernsey have historically been the most popular domiciles for captive formations, many of the captives formed today are in the United States. Shanique Hall, Recent Developments in the Captive Insurance Industry, CENTER FOR INS. POL’Y & RES. NEWSL., 10 (Jan. 2012), http://www.naic.org/cipr_newsletter_archive/vol2_pdf_version.pdf. For example, Delaware, which is now competing with Hawaii to become the third largest United States captive domicile for active captives behind Utah and Vermont, has experienced a recent level of growth that is unprecedented in the captive insurance world. In July 2009 there were only 38 captive insurers in Delaware. The State has since achieved a 558 percent growth rate in terms of licensing captive companies, and a 1,500 percent growth rate in total licensing of captive entities. Insurance Commissioner Stewart Announces That Delaware Captives Are On The Rise, NEWS.DEL.GOV (Jan. 24, 2013, 5:12 PM), http://news.delaware.gov/2013/01/24/insurance-commissioner-stewart-announces/.


5. While the “follow the fortunes” doctrine and follow the settlements doctrine are often viewed interchangeably by commentators and courts, they are considered by some to have different purposes. Historically, the “follow the fortunes” doctrine focuses on underwriting and coverage of the reinsured, whereas follow the settlements focuses on the reinsured’s settlements of the underlying claims. Edmond Rondepierre, et al., Reinsurance: Indemnifying Insurers for Insurance Losses, Reinsurance, in REINSURANCE 1, 26 (Robert W. Strain, Rev. ed. 2005).


7. See The American Ins. Co. v. American Re-Ins. Co., Civ. No. 05-01218, 2006 U.S. Dist. LEXIS 95801, at *15 (N.D. Cal. Nov. 27, 2006), citing North River Ins. Co. v. Employers Reins. Corp, 197 F. Supp. 2d 972, 984-86 (S.D. Ohio 2002) (“It seems logical that if the ‘follow the settlements’ doctrine was so widely accepted as an inherent part of every reinsurance contract that the doctrine may be read into every certificate as a matter of law, there would be no need to include such clauses in reinsurance contracts.”); see also Employers Reins. Corp. v. Laurier Indem. Co., 8:03CV1650 T17MSS, 2007 U.S. Dist. LEXIS 45670, at *11 (M.D. Fla. June 25, 2007) (refusing to imply a “follow the fortunes” provision where there was not one in the reinsurance contract).


11. See Kenneth R. Thompson, REINSURANCE 55 (4th ed. 1966) (“‘Good faith’ is the backbone of the whole system.”).


13. See Gerling Global Reins. Co. v. ACE Property & Cas. Ins. Co., 42 Fed. Appx. 522, 523 (2d Cir. 2001) (applying New York law) (where Second Circuit Court of Appeals held that, if ACE knew of the existence of asbestos litigation at the time the reinsurance contract was formed, but failed to relay this information to the reinsurer, then, pursuant to the duty of utmost good faith, the reinsurance contracts were void or voidable).

14. Unigard, 4 F.3d at 1069.


16. For example, the California Insurance Code, Section 622, requires *disclosure by the ceding insurer to the
reinsurer of all the representations of the original insured, and also all the knowledge and information possessed by the insurer whether previously or subsequently acquired that is material to the risk.” CALIFORNIA INSURANCE LAW AND PRACTICE, Sec. 11.03[1] (Matthew Bender ed., 2004) (emphasis added).


20. See Unigard 4 F.3d at 1069 (holding that a reinsurer must demonstrate, at a minimum, that its reinsured acted with gross negligence or recklessness in order to prove bad faith, i.e., a breach of the duty of utmost good faith).

21. See Amerisure Mut. Ins. Co. v. Global Reins. Corp. of America, 927 N.E.2d 740, 749-50, (Ill. App. Ct. 2010) (where the Illinois Appellate Court held that the concept of “bad faith” as it applies to an insurer under the Illinois statutory code may not even apply to a reinsurer, and therefore the breach of the common law duty of utmost good faith in the reinsurance context may not give rise to a right to attorneys fees as would exist in the direct insurance context).


25. Id. at 242, citing Unigard, 4 F.3d at 1069.


