UTMOST GOOD FAITH in US REINSURANCE LAW:  
THE NEW WORLD’S VIEW of an OLD CUSTOM and PRACTICE

Utmost good faith is an honored tradition in reinsurance relationships. From a legal perspective, utmost good faith is a doctrine which establishes parameters for the behavior of parties to a reinsurance agreement. In an early decision, a New York court summarized those parameters: “utmost good faith requires the ceding company to disclose every “fact and circumstance which can possibly influence the mind of any prudent and intelligent insurer, in determining whether he will underwrite the policy … or at what premium he will underwrite it.”

Utmost good faith is a mutual obligation that requires the reinsured to place the underwriting reinsurer in the same situation as himself and vice versa. Utmost good faith does not require the reinsurer to inquire about material facts. Instead the party seeking reinsurance must make voluntary and unsolicited disclosures. Failure to disclose material facts related to risk of loss may render a reinsurance contract voidable or rescindable.


---

1 Stephen W. Schwab and Holly M. Spurlock. Originally published with Ling Ong & Emily Bourne as Whatever Happened to the Concept of ‘Utmost Good Faith’?, Reinsurance 38 (February 2006).
Arbitration has become the tribunal of choice for resolving reinsurance disputes, but parties increasingly enlist courts to settle conflicts. Over the last twenty years, reinsurance litigants have sought judicial guidance in applying utmost good faith to modern reinsurance disputes. The courts have chronicled changes in the way reinsurance has been transacted over time and fashioned rules for resolving reinsurance disputes, but it is fair to say that these rules do not always accord with what some perceive to be industry “custom and practice.”

From an historical perspective, courts and commentators note that reinsurance originally was transacted as a “gentleman’s agreement” made within an “old boys network.” The courts observe, however, that reinsurance transactions now are subject to numerous regulatory requirements and negotiated at arms-length by sophisticated parties. Mass tort litigation and complex reinsurance arrangements among many parties sharing risks that not infrequently reach into the billions of dollars also have changed the nature and structure of reinsurance relationships. As the relationship between reinsurance parties and the form of their arrangements have evolved, litigation has increased sometimes involving judicial scrutiny of the duty of utmost good faith.

From a legal perspective, reinsurance agreements are “contracts,” and US courts begin their analyses with the document’s wording. The general rule is that contracts must be construed according to their terms. Some terms are express while others are implied or supplied by law. This distinction has led some courts to reject reinsurers’ arguments that utmost good faith is the standard for cedent behavior in every reinsurance arrangement, absent explicit language in the parties’ contract adopting or incorporating that standard. Consistent with this approach, courts are focusing on the nature and structure of the relationship and form of agreement between reinsurance parties.
It is becoming increasingly important for parties in US reinsurance court litigation to address the specific form of reinsurance arrangement, as well as the contract wording. In the view of an Illinois federal district court in *PXRE Reins. Co.*\(^{10}\), treaty reinsurers, by the very nature of the arrangement, rely on the primary insurer’s evaluation of existing and future individual risks, while facultative reinsurers have the opportunity to “kick the tires” and fully evaluate the “finite” risk to be assumed. Similarly, proportional treaty reinsurers may be perceived to rely more heavily on their cedent partners to guard their interests “ground up, from dollar one,” while non-proportional reinsurers may be said to have simply agreed to pay a limited amount above the stated retention.

Reinsurance business people, however, eschew such distinctions as fundamentally inconsistent with the nature of reinsurance as a “sharing” of risk among business “partners.”\(^{11}\) *PXRE* suggests that if they want utmost good faith to apply in a dispute, reinsurance professionals should consider taking precautionary measures when drafting their agreements such as omitting an integration or “merger” clause, or including an express provision applying utmost good faith in the text of the agreement.

The courts also have clarified the duty of utmost good faith in at least two significant ways. First, a rising number of courts have concluded that the duty is not a true legally cognizable fiduciary duty.\(^{12}\) Because both parties to a reinsurance contract are experienced, sophisticated financial institutions, these courts hold that neither party is entitled to claim that it really relies on the other, so no fiduciary relationship – and duty – may be said to exist between them, unless their agreement says so expressly.\(^{13}\)

Second, a significant number of courts require that a reinsurer seeking rescission for breach of the duty must prove affirmative bad faith (if not intent to deceive) by the cedent and/or
that they (the reinsurer) have suffered demonstrable prejudice in order to prevail. For example, in *Unigard Sec. Ins. Co., Inc. v. North River Ins. Co.*, the reinsurer alleged that the primary insurer did not disclose its decision to sign an agreement in mass tort litigation that limited its rights against insureds. The United States Court of Appeals for the Second Circuit held that because the information regarding risks of certain insurance lies with the ceding insurer, the reinsurer depends on utmost good faith and full disclosure from the cedent. The court acknowledged that absent full disclosures by the cedent, the reinsurers would be forced to duplicate actuarial and claims-handling efforts of ceding insurers and the economics would cause an end to reinsurance. Nevertheless, the Court held rescission was not warranted because the reinsurer had not demonstrated that the primary insurer’s concealment of information amounted to “bad faith” or “prejudiced” the reinsurer. Other courts have followed *Unigard*.

Some reinsureds have interpreted these clarifications as a sign of the courts’ willingness to erode the doctrine. As a result, they increasingly argue for the replacement of the duty of utmost good faith with *caveat emptor*. *Caveat emptor* shifts the responsibility from one of disclosure to one of inquiry. A number of American courts thus far still reject the reinsured push for *caveat emptor*.

For the time being, commentators are positioning themselves on both sides of the issue. Some argue that the “business” realities of the modern reinsurance industry have eliminated the mutual trust aspect of reinsurance relationships and so the duty of utmost good faith is no longer appropriate. Others insist that the “economic” realities of evaluating risks require the duty of utmost good faith to be upheld or reinsurance simply will disappear from the marketplace.

---

Utmost good faith is described as a reciprocal doctrine. The nature of the reinsurance relationship, however, requires the reinsurer to more often rely on representations of the insured. Graydon S. Staring, Law of Reinsurance 8-5 (2005).


Id.

The differences between the two are great. Arbitration clauses frequently require arbitrators be experienced current or former senior officers of (re)insurance entities who may ignore the “strict rules of law” and are to be guided in their deliberations by “industry custom and practice” to “effect the general purpose of the parties’ agreement.”


See Deborah F. Cohen, Timothy E. DeMasi, & Aaron Krauss, Uberrimae Fidei and Reinsurance Rescission: Does a Gentlemen’s Agreement have a Place in Today’s Commercial Market, 29 Tort & Ins. L.J. 602 (Spring 1994).


Lumbermens sold to Alea an existing book of business consisting of 350 treaties written on or before September 30, 1999. Lumbermens took back losses in excess of a 75% loss ratio. Effective April 10, 2000, Lumbermens ceded to PXRe a portion of this stop loss exposure. The treaty between Lumbermens and PXRe contained an integration clause which denied any representations or warranties except as stated in that contract. Prior to the cession to PXRe becoming effective, the company performed a four day due diligence examining 80 files representing 70% of the subject premium. Subsequent to the cession becoming effective, PXRe performed a routine audit and reviewed a file which, apparently, had been available during the initial due diligence but had not been reviewed. PXRe alleged that this file contained indications of a side agreement by which Lumberman’s agreed to assume unprofitable business in return for future profitable business. Rescission litigation ensued and PXRe sought extensive discovery which Lumbermens resisted.

(Held: because the parties did not expressly provide for “highest faith” in the contract, utmost good faith did not apply.)


A small number of cases have held that the duty of utmost good faith alone establishes a fiduciary relationship. See Mutuelle Generale Francaise Vie v. Life Ass. Co., 688 F. Supp. 386 (N.D. Ill. 1988).


Id.

Id.

See Steven W. Thomas, Utmost Good Faith In Reinsurance: A Tradition in Need of Adjustment, 41 Duke L.J. 1548 (June 1992) (collecting citations to commentary and opinions about weakening the duty of utmost good faith).

Id.

Id.