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NY Courts Are Both Affirming And Limiting Bellefonte

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Robert A. Kole

In the 1990 case of Bellefonte Reinsurance v. Aetna Casualty & Surety Co., the Second Circuit issued one of the most important — and, at least in some circles, controversial — decisions in reinsurance jurisprudence when it held that a reinsurer was not liable for its cedent's defense costs above the liability limit stated in a facultative reinsurance certificate. Despite several challenges over the years, federal and state courts in New York consistently reaffirmed Bellefonte's core holding. Against this backdrop, a handful of recent decisions have both confirmed the continuing vitality of Bellefonte after 25 years and identified potential avenues for expanded reinsurance recoveries in certain circumstances.

Bellefonte Sets the Stage

In Bellefonte, the Second Circuit reviewed and affirmed the district court's decision that the at-issue reinsurance certificates' overall liability limit applied to expenses, in addition to losses. The lower court action was resolved on cross-motions for summary judgment, with each party arguing that the certificates were unambiguous, eliminating the need for extrinsic evidence. As a result, the Second Circuit limited its review to the text of the certificates. At the outset, the court noted that it would construe the certificates like any other contract, aiming to give effect to each material provision. The certificates' first provision stated that Bellefonte would reinsure Aetna "in respect of the Company's contract hereinafter described … and subject to the terms, conditions and amount of liability set forth herein ...." The next provision stated that Aetna ceded $500,000 of its liability in the layer between $10 million and $15 million to Bellefonte. Reading these provisions together, the court reasoned that each subsequent provision of the certificates would be subject to the $500,000 liability cap, including in particular coverage for defense costs.

Aetna made two textual arguments, both of which the court rejected. First, Aetna contended that the "follow the fortunes" clause in the certificates meant that Bellefonte had to pay its proportional share of expenses. Bellefonte agreed that it was obliged to follow Aetna's fortunes up to the stated limit, but disputed the insurer's assertion that Bellefonte was liable beyond the limit. The court, refusing to "strip the limitation clause and other conditions of all meaning," rejected Aetna's argument. Noting that eliminating the limit would undermine the plain language of the agreement, the court held that the "follow the fortunes" clause did not supersede the stated limit. Instead, the clause was meant to coexist with the limit.

Aetna next argued that Provision Four of the certificates specifically rendered the limit exclusive of expenses. The provision stated that Bellefonte would be bound by the settlement of underlying claims, "and in addition thereto," also bound to pay "its proportion of expenses … incurred by [Aetna] in the investigation and settlement of claims or suits." The court rejected this argument too, concluding that the phrase "in addition thereto" simply differentiated the types of potential liability under the certificate. The court ended its opinion with a succinct interpretation of the liability limit's effect on the certificates' other provisions: "The reinsurers are only liable to the extent of the risk they agreed to reinsure. They cannot be liable for the insurer's action in excess of the agreement."

Bellefonte's Progeny

In the years following the Bellefonte decision, arbitration panels repeatedly were asked to resolve the issue of whether a reinsurer was obligated to pay expenses in addition to the stated liability limits of a reinsurance contract, with decidedly mixed outcomes. The Second Circuit, however, did not waver in its holding. Unigard Security Insurance v. North River Insurance, decided in 1993, involved a certificate with materially identical language to the agreements in Bellefonte, with a modest twist: the underlying policy was cost-exclusive and, before Bellefonte was decided, Unigard itself had interpreted its reinsurance contract limit to be exclusive of defense expenses. North River, the cedent, argued that the certificate's "follow the form clause" directly tied the reinsurance limit to the underlying limit.

The Second Circuit rejected North River's contention, and firmly reaffirmed Bellefonte. It noted that the certificate made the "follow the form" clause expressly subject to its other provisions, including the liability limit. Even though the parties may have understood the spirit of the underlying policy to be controlling, the court decided that the terms of the certificate governed the insurer-reinsurer relationship. Thus, despite the contrary past practices of the parties, Bellefonte's "gloss [was] conclusive." As in Bellefonte, the reinsurance certificate's liability limit set a hard cap on Unigard's total exposure.

The court framed its holding as a matter of policy. It explained that "[h]istorically, the reinsurance market has relied on a practice of the exercise of utmost good faith to decrease monitoring costs and ex ante contracting costs." It then questioned whether an industry "that has relied upon informal understandings and practices" to avoid disputes and minimize costs could thrive in a newly litigious atmosphere spurred by huge environmental losses. Thus, in issuing its holding, the court pointed to stability and predictability as justifying a strong reaffirmance of Bellefonte: "The efficiency of the reinsurance industry would not be enhanced by giving different meanings to identical standard contract provisions depending upon idiosyncratic factors in particular lawsuits. The meaning of such provisions is not an issue of fact to be litigated anew each time a dispute goes to court."

Some observers suggested that Bellefonte was confined to the Second Circuit, and that it might not be the controlling law of New York. But, in the 2004 case of Excess Insurance v. Factory Mutual Insurance, the New York Court of Appeals examined a certificate reinsuring the cedent's underlying property policy. 822 N.E.2d 768 (N.Y. 2004). The literal terms of the certificate, while establishing a liability limit, did not mirror those in Bellefonte and Unigard. Nevertheless, the court noted that it was "follow[ing] the decisions of the United States Court of Appeals for the Second Circuit" in deciding that the reinsurer was not liable for expenses above the stated liability limit — and disappointing those who thought that Bellefonte might be rejected in New York. The court went on to reason that if the insurer intended to make the reinsurer's liability limits expense-exclusive, it could have expressly stated as such in the agreement, or negotiated a separate limit for expenses. The dissent argued that the parties' intent was ambiguous, and pointed to several sources of doubt: the allegedly confusing language of the certificate, the fact that the certificate was agreed to months before Bellefonte was decided, the rampant criticism of Bellefonte in the industry and the decades of consistent, contrary practice. Accordingly, the dissent would have remanded the case to allow the lower court to weigh extrinsic evidence while interpreting the agreement.

Affirming and Limiting Bellefonte

In the past year, courts in the Second Circuit have been asked to continue to apply Bellefonte, with somewhat mixed results. In Utica Mutual Insurance v. Clearwater Insurance, the insurer argued that the facultative certificates were ambiguous, thus requiring extrinsic evidence for their interpretation. 2014 U.S. Dist. LEXIS 162645 (N.D.N.Y. Nov. 20, 2014). Whereas the certificates in Bellefonte and Unigard explicitly provided that the agreement was "subject to" "the … amount of liability" (Bellefonte) or the "limits of liability" (Unigard), the certificates in Utica Mutual did not use the same phrasing to cap the reinsurer's liability. Instead, the Utica Mutual certificates described the reinsurer's "share" as a percentage of the underlying policy limit, leading the insurer to contend that there was no unambiguous liability cap because the certificates did not "specifically use the word 'limit.'" Rejecting this argument, the court reasoned that "a percentage share of a policy limit is itself a limit on liability." As a result, in the court's eyes, the lack of the word "limit" was "of no moment."

In Global Reinsurance v. Century Indemnity, the U.S. District Court for the Southern District of New York applied Bellefonte in a seemingly clear-cut fashion. 2014 U.S. Dist. LEXIS 113793 (S.D.N.Y. Aug. 15, 2014). The certificates at issue were very similar to those in Bellefonte. Century, the reinsured, tried to distinguish its facts by arguing that the underlying policy paid expenses above the limits for loss, unlike the underlying policy in Bellefonte. The court rejected this argument, noting that the underlying policy limit was expense-exclusive in Unigard, too. Century also argued that Bellefonte did not apply, because the certificate language was not exactly the same. The court rejected this argument as well, reasoning that although some of the certificate language was different from Bellefonte's, the relevant terms — specifically the cap on liability — were nearly identical and dispositive. Because the rest of the agreements' provisions were "subject to" the cap, the district court followed Bellefonte's instruction that "[a]ll other contractual language must be construed in light of that cap."

However, in Utica Mutual Insurance v. Munich Reinsurance America, the Second Circuit indicated that it will not use Bellefonte to rubber-stamp liability caps as expense-inclusive, if the certificate's language does not support such a reading. In Utica I, the U.S. District Court for the Northern District of New York examined whether the liability cap in a reinsurance certificate was expense-inclusive. 976 F. Supp. 2d 254 (2013). Citing Bellefonte, Unigard and Excess, the court started by presuming that when a certificate's limit is silent as to expenses, it should be deemed to be unambiguously expense-inclusive.

Utica, the reinsured, argued that the certificate's limit was expense-exclusive, or at least ambiguous. The certificate treated losses differently from expenses; while the loss provision explicitly subjected liability to the limit, the expense provision was silent. Utica thus asserted that the certificate, through omission, impliedly excluded expenses from the liability limit. The district court ultimately rejected Utica's argument, because there was no express language in the certificate excluding expenses. Further, the court noted a perceived inconsistency in Utica's position: the settlement provision was also silent as to the limit, yet Utica "repeatedly acknowledged" that settlements were subject to it. Thus, the court deemed the certificate's limit unambiguously expense-inclusive, and refused to consider extrinsic evidence.

In so holding, the district court recognized Utica's argument that custom and practice militated against a presumption of cost-inclusiveness. Nevertheless, the court noted that "[w]hatever the merits of this assertion, any such error is for the Second Circuit and the New York Court of Appeals … to remedy."

In Utica II, the Second Circuit accepted the district court's invitation. 2014 U.S. App. LEXIS 22765 (Dec. 4, 2014). The Second Circuit's conclusion was fairly simple — the certificate was ambiguous, such that extrinsic evidence should be considered to interpret it. The drafter's choice to expressly subject losses, but not expenses, to the limit at least implied exclusion of expenses. On the other hand, the court also found the district court's interpretation of the certificate to be plausible. Because neither was decisive, the court concluded that the effect of the limit was ambiguous. Accordingly, the court vacated the judgment and remanded the case so that extrinsic evidence could be considered.

The important takeaway from Utica II is that Bellefonte's presumption of cost-inclusiveness can be rebutted. Instead of summarily subjecting all certificate provisions to a liability limit, the court reiterated the need to closely scrutinize the text in an exercise of contractual interpretation. Thus, the court rejected the district court's reading of Excess to require express language in order to rebut any presumption of cost-inclusiveness. Rather, the analysis is less formulaic. If the plain language of the certificate is ambiguous, then extrinsic evidence is necessary; on the other hand, if the text is facially clear, it will be construed to give its terms effect, even if the effect of the plain language is arguably contrary to custom.

After Utica II, Century appealed the Global Reinsurance decision referenced above, arguing that Utica II opens the door for extrinsic evidence to be considered. It will be interesting to see how far courts, in New York and elsewhere, go in allowing challenges to Bellefonte-type liability caps. At a minimum, insurers may want to carefully scrutinize their contract language to determine whether arguments exist for expanded coverage of expenses in excess of liability caps.

—By Robert A. Kole and Kevin J. Finnerty, Choate Hall & Stewart LLP

Robert Kole is co-chairperson of Choate Hall & Stewart's insurance and reinsurance group in the firm's Boston office.

Kevin Finnerty is an associate in Choate Hall & Stewart's Boston office.

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