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Insurance

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A commentary article reprinted from the April 15, 2020 issue of Mealey's Litigation Report: Insurance

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Commentary

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This article will address a few of the most prominent reinsurance issues arising from the COVID-19 pandemic.

Follow the Fortunes and Follow the Settlements

If an insurer pays, or is forced to pay, a claim for COVID-19 business interruption losses, the insurer will likely turn to its reinsurers for coverage. Many reinsurance contracts contain a provision that requires a reinsurer to follow the fortunes and/or settlements of the cedent.

A typical "follow the fortunes" clause states:

> The liability of the Reinsurer shall follow that of the Cedent in every case and be subject in all respects to all the general and specific stipulations, clauses, waivers and modifications of the Cedent's policies and any endorsements thereon. However, in no event shall this be construed in any way to provide coverage outside the terms and conditions set forth in this Contract.

The follow the fortunes provision generally means that a reinsurer must follow the underwriting fortunes of its reinsured even if the reinsured's underwriting produces bad results.

A follow the settlements clause imposes similar obligations on the reinsurer in the context of settlements. A typical follow the settlements provision states: "Reinsurers agree to follow all settlements (excluding without prejudice and ex gratia payments) made by original insurers arising out of and in connection with the original insurance . . ." Follow the fortunes and follow the settlements are often treated interchangeably and we will do so for the remainder of this article.

The purpose of the follow the fortunes doctrine is to prevent a reinsurer from second-guessing the good faith decisions of the ceding insurer. As one court explained: "The follow-the-fortunes doctrine binds a reinsurer to accept the cedent's good faith decisions on all things concerning the underlying insurance terms and claims against the underlying insured: coverage, tactics, lawsuits, compromise, resistance or capitulation." North River Ins. Co. v. Ace American Reins. Co., 361 F.3d 134, 139–40 (2d Cir. 2004). The doctrine is not unlimited, however. Under the follow the fortunes doctrine, a reinsurer can deny payment if (1) the cedent engaged in fraud, collusion or bad faith or (2) the losses are not covered under either the underlying insurance policies or the reinsurance treaty.

With this background in mind, if a cedent voluntarily pays a business interruption claim where the underlying contract requires physical damage or has a virus exclusion, the cedent will likely face substantial difficulties recovering from its reinsurers for such losses. Indeed, in order for there to be coverage under a reinsurance contract, there must be coverage under the cedent's policy. A cedent may face similar difficulties recovering from its reinsurers if it voluntarily pays COVID-19 claims that fall outside the terms of the reinsurance contract.

The more difficult question is what if a ceding company makes a determination that COVID-19 was present and caused physical damage on the insured premises? Would the reinsurer be required to follow this determination? Cedents will undoubtedly argue that the reinsurer must follow the cedent's determination that physical damage was present and pay the loss without relitigating or second-guessing the coverage issues. Reinsurers will counter that only coverage determinations made in good faith and in a businesslike fashion need to be followed. What proof of physical damage will suffice to satisfy the reinsurers that the settlement was not an -ex gratia payment, but rather was made in good faith?

Another issue that might arise is, what happens if the states or federal government, through legislation, force insurers to pay COVID-19 business interruption losses? Do reinsurers have an obligation to follow the fortunes of their cedents? It is generally understood that a reinsurer is required to follow the fortunes of its cedent in the face of an adverse ruling in court or arbitration proceedings. However, would the same rule apply if the government re-writes an insurance policy to provide for coverage where coverage previously did not exist? Such questions might be further complicated if there is a relevant difference in scope between the underlying coverage and the reinsurance coverage.

Still the more difficult question appears to be what happens if a cedent pays a COVID-19 claim based on mere pressure from lawmakers or regulators to waive its defenses for the common good. Reinsurers may categorize such payments as ex gratia and refuse to follow those settlements, especially if they were not consulted by the cedent prior to claim payment.

Aggregation of Losses in Excess of Loss Reinsurance Treaties

Excess of Loss reinsurance is a form of reinsurance intended to protect insurers against catastrophic losses arising from a single "event" or "cause" limited in time and space, such as a hurricane or a fire. Excess of loss reinsurance contracts typically contain a provision allowing a ceding company to combine multiple loss occurrences so that only one retention need be satisfied so long as those loss occurrences can be linked to a common "event" or "cause."

If an insurer pays, or is forced to pay, a claim for COVID-19 losses, the question that is almost certain to arise in the reinsurance context is whether COVID-19 is a single "event" or "cause" such that the cedent can aggregate its losses to satisfy its retention? The starting point in the analysis must begin with a review of the contract wording.

"Event" Based language.

Common "event" based language in a reinsurance contract provides:

> The term 'loss occurrence' shall mean the sum of all individual losses directly occasioned by any one disaster, accident or loss or series of disasters, accidents or losses arising out of one event which occurs within the area of one state of the United States or province of Canada and states or provinces contiguous thereto and to one another. However, the duration and extent of any one 'loss occurrence' shall be limited to all individual losses sustained by the Companies occurring during any period of 168 consecutive hours arising out of and directly occasioned by the same event, except that the term 'loss occurrence' shall be further defined as follows:
>
> As regards to windstorm, hail, tornado, hurricane, cyclone, including ensuing collapse and water damage, all individual losses sustained by the Companies occurring during any period of 96 consecutive hours arising out of and directly occasioned by the same event. However, the event need not be limited to one state or province or states or provinces contiguous thereto.

Based on the best available evidence, it appears that the novel coronavirus that causes COVID-19 originated in Wuhan, China sometime in late 2019. If the "event" is defined as the initial spread of the coronavirus in Wuhan, China in late 2019, it is clear that the cedent would not be able to aggregate its COVID-19 losses (assuming they are covered under the insurance policy and the reinsurance agreement) for failure to satisfy the geographic and time-related scope of the above provision.

However, similar to what happened in the context of asbestos, pollution, and health hazard claims, insureds (and cedents) will no doubt employ creative arguments

to describe a covered "event." For example, in most of the business interruption cases filed to date, the insured has argued that governmental "stay-at-home" orders requiring businesses to cancel events and prohibit public gatherings caused the insured's COVID-19 losses. For example, if a cedent pays the business interruption claims of an Illinois insured on the basis of the Illinois Governor's March 20, 2020 stay-at-home order, the cedent might be able to aggregate its Illinois losses as one "event." Given the contractual limitations on time and space, the same cedent would have a difficult time arguing that it could aggregate losses out of Illinois' March 20, 2020 order with Florida's stay-at-home order, which went into effect on Friday, April 3, 2020.

"Cause" based language

A cedent may aggregate its losses that arise out of the same "common cause," "arising from one originating cause," or something to that effect. A clause that allows aggregation of losses arising out of an "originating cause" or a "common cause" is concerned with the underlying reason why the losses occurred, rather than the occurrence of the losses themselves. This language will likely allow for aggregation of a larger number of claims than the "event" based wording described above.

In sum, the extent to which a cedent will be permitted to aggregate its losses will depend on several factors, including the treaty language and the aggregation theory upon which the claim is presented to the reinsurers.

Legislative Action

As reported in a previous Locke Lord QuickStudy, New Jersey Advances a Bill Providing Business Interruption (Bi) Coverage Resulting from COVID-19,[1] many state legislatures have contemplated enacting laws that direct insurers to pay business interruption claims even where such claims are not within the terms of coverage or are expressly excluded under the insurance policy. Moreover, a bipartisan group of Congress members known as the Problem Solvers Caucus has proposed federal legislation requiring insurers nationwide to pay business interruption claims related to the COVID-19 pandemic. These measures suggest an acknowledgement by lawmakers that coverage for business interruption losses is generally unavailable in the existing insurance market.

If state or federal legislation forces insurers to provide coverage for business interruption claims, can such legislation be extended to reinsurers and retrocessionaires doing business in the United States? If the goal of such legislation is to spread risk, then one might expect that reinsurers and retrocessionaires will also be required to pay COVID-19 losses. Indeed, requiring reinsurance companies to pay COVID-19 claims may be important to maintaining the solvency of the insurance companies that purchased the reinsurance. We anticipate that both insurers and reinsurers will challenge such legislation under the U.S. and state constitutions.

Please visit Locke Lord's COVID-19 Resource Center[2] often for up-to-date information to help stay informed of the legal issues related to COVID-19.

Endnotes

1. https://www.insurereinsure.com/2020/03/17/new-jersey-advances-a-bill-providing-business-interruption-bi-coverage-resulting-from-covid-19/.

2. https://www.lockelord.com/covid19resourcecenter. ■

MEALEY'S LITIGATION REPORT: INSURANCE
edited by Gina Cappello
The Report is produced four times a month by

1600 John F. Kennedy Blvd., Suite 1655, Philadelphia, PA 19103, USA
Telephone: (215)564-1788 1-800-MEALEYS (1-800-632-5397)
Email: mealeyinfo@lexisnexis.com
Web site: http://www.lexisnexis.com/mealeys
ISSN 8755-9005