

Resolving Conflict Between District Courts, Second Circuit Rules That Defense Costs Are Subject To Reinsurance Limits

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The Second Circuit ruled that facultative reinsurance certificates issued by Munich and Century reinsured defense costs within limits, not in addition to them. *Utica Mut. Ins. Co. v. Munich Reins. Am., Inc.*, 2021 WL 3197017 (2d Cir. July 29, 2021).

Utica sought reinsurance from Munich and Century for losses paid to its insured for asbestos-related claims. Disputes as to the existence and scope of coverage under certain certificates resulted in two separate lawsuits in New York federal district court. In one suit, the court ruled in the reinsurer's favor, finding that Utica's defense costs were subject to policy limits. In the other suit, a different judge ruled that defense costs were in addition to policy limits. The Second Circuit, hearing the appeals in tandem, ruled that defense costs eroded policy limits and were not supplemental to them.

Because the reinsurance coverage "followed form" to Utica's umbrella policy, the central issue in dispute concerned the application of Utica's umbrella policy. Utica acknowledged that the umbrella policy made defense costs subject to policy limits, but argued that the policy was modified by an endorsement that allowed defense costs to be in addition to limits. The Second Circuit rejected this assertion, explaining that the endorsement, which expressly applied to "any occurrence not covered by" the primary policy, was unambiguous and referred only to scenarios in which the umbrella policy "dropped down" to provide primary coverage in the first instance because the primary policy did not cover the particular claims. The court explained that the endorsement did not apply where, as here, the primary policy provided coverage and umbrella policy was triggered by virtue of exhaustion of the primary policy limits.

In addition, the court deemed unpersuasive Utica's assertion that the facultative certificates required the reinsurers to reimburse the disputed defense costs, regardless of Utica's own obligations under its umbrella policy. Utica claimed that it was entitled to bill the reinsurers for defense costs in addition to policy limits because the certificates bound the reinsurer to pay all "expenses incurred" by Utica. The court held that Utica's construction "violates the contractual intent of facultative reinsurance" which connects a reinsurer's liability to the cedent's liability under the operative policy. More specifically, the court explained that "incur" means "to become liable or subject to" and thus requires a legal liability to pay. Under the follow form clauses, the reinsurers' liability is tied to coverage under Utica's umbrella policy. The court stated: "[t]he only 'expenses incurred' that the reinsurers must reimburse are those that Utica is liable to pay under the 1973 umbrella policy (or good faith, reasonable settlements of disputes affecting that policy and within its terms)."

Finally, the court ruled that Century was entitled to a new trial on its bad faith counterclaim against Utica. The counterclaim alleged that Utica violated its duty of good faith by improperly billing Century for defense costs in addition to limits, among other things. The district court had instructed the jury that an essential element of the bad faith counterclaim was a finding that Century fulfilled its obligations under the reinsurance certificate and that “this element is in dispute.” The Second Circuit deemed these instructions erroneous, explaining “there is no actual dispute whether Century did all it was obligated to do under the 1973 certificate. As a matter of law, Century is not obligated under the certificate to pay defense in addition to limits—the only pertinent issue at trial regarding Century’s obligations.”

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