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MEMORANDUM

Law Firm LLP

January 23, 20xx

FROM: Associate Attorney

TO: Partner

RE: The Defense of Late Notice/ Reinsurance Treaty xxxxxxxxxx
Claim No.: 0539035
Our Client #: 350763-00002

I. SCOPE OF MEMO:

This memo discusses the adequacy of the December 5, 2002 "precautionary notice" letter from *INSURER* to *REINSURER* under the referenced reinsurance treaty. The memo concludes with a discussion of whether and how *REINSURER* would have to show it was prejudiced by the late notice to defeat the claim for indemnity.

II. SHORT ANSWER

Two New York federal court decisions constitute persuasive authority to support *REINSURER*'s denial of coverage based on *INSURER*'s inadequate and late notice. *REINSURER*, however, will have to prove it was prejudiced, preferably in some tangible economic form, before it can be relieved of its obligations under the contract.

III. CONTRACT LANGUAGE[1]

ARTICLE IX

CLAIMS. The REINSURED agrees that it will investigate and will settle or defend all claims arising under policies with respect to which reinsurance is afforded by this agreement, and that it will give prompt

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[1] Preliminary research has uncovered no case law addressing whether an "Error and Omissions" clause, such as that found in Article XIII of the reinsurance treaty, can provide a ceding insurer a defense to a claim of late notice. One practicing law handbook, however, noted that "[t]he E&O clause has not been frequently raised in disputes between cedants and reinsurers, which underscores the general industry recognition that it is not intended to broaden coverage or relax reporting requirements." James A. Allen, Myra E. Lobel, Maxine H. Verne, The Future Of Reinsurance Contracts, 825 PLI/Comm. 165, 172-175 (Oct 1-2, 2001).

notice to the CORPORATION of any claim in excess of the REINSURED'S applicable retention and prompt notice of any other event or development which could involve the CORPORATION hereunder, and will forward promptly to the CORPORATION copies of such pleadings and reports of investigation as may be requested by the CORPORATION.

IV. NOTICE TIMELINE

January 29, 1992: ..... Explosion and loss. *INSURER* defends Federal in various state court actions, including Paul Lodati v. Federal Env. Serv., Inc., under reservation of rights.

December 22, 1993:..... Notice to *REINSURER* from *INSURER* of lawsuit attaching "Major Loss Report", some legals and some correspondence with attorneys.

c. 1994 ..... Declaratory Judgment Action filed by *INSURER* in federal court in Georgia.

April 18, 1995 ..... John Doe of *INSURER*, who "just assumed the further responsibility for handling of this file," forwards numerous defense attorney report letters from April 1994 through March 1995, and notes that "discovery has been stayed pending the ruling on our Motion for Summary Judgment."

July 12, 1995..... *REINSURER* Diary entry in "Excess Loss Claim File Sheet" noting receipt of Golembiewski letter and that "latest update" was 3/95. Also provides that "Defense is progressing well. Witness are providing evidence to refute claims of post traumatice (sic) stress induced by the explosion. Continue to Monitor."

July 25, 1995..... Schwartze of *REINSURER* acknowledges receipt of April 18, 1995 letter and advises that he "look[s] forward to receiving

periodic updates as the matter develops further."

c. January 1996 ..... Summary Judgment motions in D.J. action denied.

February 15, 1996 ..... *REINSURER* Diary entry in "Excess Loss Claim File Sheet" noting: "Contact insured for update."

April 9, 1996 ..... Perkins v. Federal Env. Serv., Inc. tort action filed in state court in Florida.

April 11, 1996 ..... Settlement and Release of *INSURER* from all liability from suits related to the explosion.

May 30, 1996..... *REINSURER* Diary entry in "Excess Loss Claim File Sheet" noting that "Call from cedant in response to my earlier inquiry. Report exposure has not changed. Continue to Monitor."

October 18, 1996..... *REINSURER* Diary entry in "Excess Loss Claim File Sheet" noting: "Recap. No further activity reported on claim. Continue to monitor to determine if there is a reasonable exposure to the ceded policy."

May 30, 1997..... Counsel in Perkins retained by *INSURER* to represent Federal seeks permission to withdraw from Federal's defense.

June 19, 1997..... *REINSURER* Diary entry in "Excess Loss Claim File Sheet" noting: "Reviewed File and Recent information and determined that exposure has not changed. Diary for additional review."

July 28, 1997..... Order issued allowing *INSURER* to withdraw from defense of Federal.

? ..... Summary judgment granted against Federal in Perkins case on liability. No

INSURER involvement with this action at this time.

December 3, 1997 ..... *REINSURER* Diary entry in "Excess Loss Claim File Sheet" noting: "Reviewed File, risk does not create exposure at this level of coverage. Close for now."

? August 1998 ?..... Trial on damages in Perkins action ends in jury verdict against Federal for $40,150,000.

September 3, 1998..... Final Judgment entered in state court in Perkins against Federal for $40,150,000.

December 1998 ..... Federal Files for Bankruptcy.

December 9, 1998 ..... Plaintiffs in Perkins action file suit against *INSURER* seeking recovery on policies issued to Federal, in Florida state court: Ernest Grace v. *INSURER* Ins. Co.

January 7, 1999..... Ernest Grace removed to Florida federal court.

February 29, 1999 ..... Plaintiffs in Ernest Grace offer to settle for policy limits of *INSURER* policy of $1 million.

March 1999..... *INSURER* rejects settlement offer.

April 2, 1999 ..... Plaintiffs in Ernest Grace amend complaint to seek recovery of judgment in excess of policy limits.

May 3, 1999..... *INSURER* files motion to dismiss.

January 6, 2000..... Motion to dismiss denied.

March 9, 2000 ..... *INSURER* files motion for summary judgment.

July 14, 2000..... *INSURER* files 2nd motion for summary judgment.

October 26, 2000 ..... Motions for summary judgment denied.

December 5, 2000 ..... *INSURER* sends "precautionary notice" letter to *REINSURER*, noting that trial set for "December 2000."

January 16-17, 2001 ..... Bench trial

September 25, 2001 ..... Judgment entered against *INSURER* for $40,150,000.

? 2002 ? ..... Letter from *INSURER's* Smith to *REINSURER* enclosing copy of $40,150,000 judgment against *INSURER*.

May 21, 2002 ..... Letter from *REINSURER*'s Carpenter to *INSURER's* Smith complaining of lack of notice and reserving all rights.

December 13, 2002 ..... Notice of settlement for $7,780,000 sent by *INSURER's* Smith to *REINSURER*'s Carpenter.

January 3, 2003 ..... *INSURER* sends Billing Notice to *REINSURER* for $4,500,000.

V. DISCUSSION

A. CASE LAW ADDRESSING THE ADEQUACY OF NOTICE OF CLAIM

Case law addressing the adequacy of a ceding insurer's notice of claim to a reinsurer is found almost entirely in the context of the late notice defense. Research has found only two cases that address the issue of the adequacy of the substance of the notice of claim.[2]

[2] Research was unable to uncover any case law in either Kansas or Missouri addressing the issue of late notice in the reinsurance context. I consequently turned to the national body of case law from other United States jurisdictions.

1. Unigard Sec. Ins. Co., Inc. v. North River Ins. Co., 4 F.3d 1049, 1068 (2d Cir. 1993)

a. Holding

In Unigard, North River, a subsidiary of Crum and Forster, was a third-layer excess insurer of Owens-Corning, an asbestos producer. Its coverage was for $30 million excess of $76 million in underlying excess and primary coverages over three policy periods from 1974-1976. Unigard reinsured North River on a facultative certificate for one sixth of North River's risk on a pro rata basis.

In Unigard the Second Circuit considered whether North River was required to give notice to its reinsurer that it had entered into the "Wellington Agreement," the adequacy of the purported notice, and the prejudice, if any, from late notice. Through the Wellington Agreement North River paid in total for both indemnity and expenses more than its stated policy limits. North River put Unigard on notice that it expected Unigard to pay its one-sixth share. Unigard declined on the basis of "late notice" and later brought a declaratory relief action against North River.

Unigard's reinsurance certificate contained the typical "prompt notice" and "right to associate" requirements: "Prompt notice shall be given by the company to the underwriting managers on behalf of the reinsurers of any occurrence or accident which appears likely to involve this reinsurance," and that the reinsurer shall "have the right and be given the opportunity to associate . . . in the defense or control of any claims . . . which may involve this reinsurance."

After deciding that the ceding insurer was required to give notice, the court considered the sufficiency of the purported notice. The insurer argued that it had provided notice of the Wellington Agreements. At issue were two communications from Crum and Forster notifying Unigard of its considerations of entry into the Wellington Agreement. Reference in those communications, however, was either to "reinsurance treaties," or did not specify a particular agreement, and these were sent to Unigard employees who handled only treaty insurance.

The Second Circuit found that the notice of the Wellington Agreement was inadequate because it did not clearly indicate the effect of the agreement on Unigard's facultative certificate. With respect to one of these communications, the court noted that:

> North River relies primarily on the Crum & Forster telex of July 18, 1984. However, that telex referenced only "General Casualty, Comprehensive Catastrophe and Casualty Contingency Reinsurance *Treaties*." (emphasis added). It made no mention of *facultative* certificates. It was addressed to Killen, who worked in the the RAD [Reinsurance Assumed Department] which handled only treaties. Although Killen, while working in the RAD from 1976 until March

> 1980, had, according to Todd, "related to the [AMAI] [Unigard's managing general agent, Allen Miller and Associates, Inc.] function" as "a person to whom certain types of coverage questions and background information on the writing of [AMAI] contracts would be addressed," he had not done so for four years. North River is correct in arguing that Unigard never notified North River of such a change. However, we cannot infer, contrary to the plain language of the telex, that it was meant to include the Certificate from the fact that Killen once "related to the [AMAI] function" while he also handled treaties.

Id. at 1066-67. The court also took note that Unigard's actions on receipt of the letters was consistent with the understanding that it applied only to treaties.

The Second Circuit also commented on the District Court's finding of adequate notice:

> The district court did state that the "Killen Telex and Murphy's October 1984 letter to [Todd] contained enough information for Unigard to have discovered the salient facts through its own investigation." [citation omitted] Perhaps, but these letters did not create a burden on Unigard to conduct such an investigation. Not only did neither of these letters contain any reference to the Certificate, but they also did not reference any facultative reinsurance. Indeed, one did not identify the ceding insurer, North River. To hold that such letters created a duty on the part of Unigard to investigate the Wellington Agreement to determine whether North River was involved, and specifically whether XS-3672 would be affected, would ignore the imperatives of the reinsurance market that reinsurers receive such information from ceding insurers. The burden of giving effective notice is thus on the party who can meet that burden at the least cost--the ceding insurer.

Id. at 1067.

In a related discussion regarding whether North River's lack of notice amounted to bad faith, the Second Circuit further explained an insurer's notice duties:

> the duty of good faith requires the ceding insurer to place the reinsurer " 'in the same [situation] as himself [and] to give to him the same means and opportunity of judging ... the value of the risks.' " Also as stated above, some commentators have difficulty characterizing contemporary reinsurance contracts as being of utmost good faith. Nevertheless, because information concerning the underlying risk lies

> virtually in the exclusive possession of the ceding insurer, a very high level of good faith--whether or not designated "utmost"-- is required to ensure prompt and full disclosure of material information without causing reinsurers to engage in duplicative monitoring.

Id. at 1069 (internal citations omitted).

b. Unigard is Helpful Authority That *INSURER's* Notice Was Inadequate

Although Unigard is not directly on point, it will be helpful authority in the instant case by analogy. The key to Unigard's holding is that the two letters at issue did not contain enough information for the reinsurer to know that a claim might be made on a particular reinsurance agreement. The lack of information caused the Reinsurer to misinterpret the notice of claim, rendering the notice ineffective as a matter of law.

In the instant case, although the December 5, 2002 "precautionary notice" letter did reference the correct agreements, it provided no new information regarding the loss that would distinguish it from the original Lodati litigation. The December 5 "notice" referenced the same policyholder, the same ceding insurer, the same date of loss, the same policy number and period, and the same description of the occurrence. The only new information the December 5 letter provided was that "A December 2000 trial date has been set."

Accordingly, having made a determination in 1997, based on information provided to it by *INSURER*, that the "risk does not create exposure at [*REINSURER*'s] level of coverage," it is arguably quite reasonable for *REINSURER* to have assumed the December 5 letter was related to the original litigation and that its potential exposure remained unchanged.

2. Constitution Reinsurance Corp. v. Stonewall Ins. Co., 980 F. Supp. 124, 129 (S.D.N.Y. 1997).

a. Holding

In Constitution Re the reinsurer brought a declaratory judgment action seeking a determination that it was not required to reimburse the reinsured for its settlement of an underlying suit because it had failed to provide prompt notice of the claim. In the underlying suit, Stonewall had denied coverage and refused to tender a defense for the insured, which than commenced an action against Stonewall on March 27, 1991. Subsequently (or possibly before the commencement of the action), the insured settled the underlying litigation for over $14 million. On May 7, 1992 Stonewall sent an "Initial Reinsurance Notice of Loss" to its reinsurer, which stated simply: "Plaintiff alleges assured sold liquor to an already intoxicated

person resulting in auto accident. We follow form to underlying policy which specifically excludes liquor liability."

The notice provision in the reinsurance contract provided that the ceding insurer had to promptly provide the reinsurer with a "definitive statement of loss" on any claim brought under the reinsurance certificate. The contract defined "definitive statement of loss" as

> [t]hose parts or Portions of the Company's investigative claim file which in the judgment of the Reinsurer are wholly sufficient for the Reinsurer to establish adequate loss reserves and determine the propensities of any loss reported hereunder.

Id. at 127-28. In holding that the insured failed to provide prompt notice, the court found that the May 7, 1992 "Initial Reinsurance Notice of Loss" did not satisfy the notice requirement of the reinsurance contract:

> The form stated only, "Plaintiff alleges assured sold liquor to an already intoxicated person resulting in auto accident. We follow form to underlying policy which specifically excludes liquor liability." . . . This cursory explanation does not mention that the accident involved two deaths nor that the underlying action had been settled for over $14 million. The earliest writing submitted in these proceedings conveying these basic facts surrounding the Economy claim is a letter from Stonewall to its reinsurers dated November 20, 1992. . . . This letter therefore is the earliest documentation presented to the Court that arguably satisfies the notice requirement of the reinsurance contract, and it was dated well over two years after Stonewall's duty to notify Constitution was triggered.

Id. at 128.

b. Constitution Reinsurance is Helpful, But Distinguishable.

Similar to the facts of Constitution Re, the *INSURER's* December 5, 2002 "precautionary notice" letter does not provide the most basic information which would have allowed *REINSURER* to set reserves or to make any determination regarding associating in the defense. On the other hand, the policy at issue in Constitution Re had a much more detailed notice requirement than the policy at issue here and is thus distinguishable. Although the policy at issue in Constitution Re defined "definitive statement of loss," we would argue that definition is nothing more than a contractual statement of the understanding in the insurance industry of the minimum requirements of notice of loss. Of course, the ceding insurer would likely argue that the inclusion of the clause itself suggests that the definition goes beyond normal custom and practice.

B. *INSURER'S* "PRECAUTIONARY NOTICE" LETTER IS INADEQUATE TO CONSTITUTE A FULFILLMENT OF ITS NOTICE REQUIREMENT BECAUSE IT SATISFIES NONE OF THE FUNCTIONS OF THE PROMPT NOTICE REQUIREMENT.

1. The Functions of the Prompt Notice Requirement.

The primary purposes of a prompt notice provision in a reinsurance contract are:

> to enable [the reinsurer] to set proper reserves covering anticipated losses, to decide whether it wishes to exercise its right to associate in the defense of a particular claim, and to establish premiums that accurately reflect past loss experience.

Christiania General Ins. Corp. of New York v. Great American Ins. Co., 979 F.2d 268, 274 (2d Cir. 1992); see also Unigard, 4 F.3d 1049, 1065 ("Prompt notice provisions in reinsurance are designed to: (i) apprise the reinsurer of potential liabilities to enable it to set reserves; (ii) enable the reinsurer to associate in the defense and control of underlying claims; and (iii) assist the reinsurer in determining whether and at what price to renew reinsurance coverage") (internal citation omitted); Highlands Ins. Co. v. Employers' Surplus Lines, 497 F. Supp. 169, 173 n. 3 (E.D.La. 1980) (stating that the purpose of the notice provision is "to afford a company which may ultimately be liable on a claim the opportunity to participate in the defense of that claim").

2. *INSURER's* Notice of Loss Was Ineffective Because It Did Not Fulfill Any of the Purposes of the Prompt Notice Provision.

Because *INSURER's* December 5, 2002 "precautionary notice" letter clearly does not appear to satisfy any of the purposes of a prompt notice provision, *REINSURER* has a persuasive argument that it does not constitute valid notice under the contract. Logic dictates that such a perfunctory notice can not enable the reinsurer to access the potential loss.

Similar to the notice at issue in Constitution Re, the December 5 *INSURER* letter provided little information beyond the most cursory description of the underlying claims. Most notably, it did not mention that a new action had been commenced, that a judgment of over $40 million had been obtained in that action, or that the ceding insurer itself had been sued for the entire underlying judgment and had rejected a settlement for the underlying policy's $1 million limits. Similarly, the failure to notify *REINSURER* of each of these events precluded *REINSURER* from setting proper reserves, associating in the defense, or establishing premiums if there were renewals of this reinsurance.

C. THE NEED TO PROVE PREJUDICE FROM LATE NOTICE

1. Implications of The Prejudice Requirement in the Direct Insurance Context.

a. Prejudice Must Be Shown Under Kansas and Missouri Law

Once a court finds that the notice requirement in a reinsurance contract has been breached it will have to determine whether the reinsurer is required to show, and can show, it was prejudiced. A court is more likely to find that a showing of prejudice is not required in the reinsurance context in jurisdictions where late notice relieves a direct insurer of its obligations without a showing of prejudice. See Barry R. Ostrager & Thomas R. Newman, Handbook on Insurance Coverage Disputes § 16.02[a], at 951 (11th ed. 2002) (collecting cases).

In this regard, both Kansas and Missouri law require a direct insurer to prove it was prejudiced by late notice before it can be relieved of its responsibilities under the policy. See ERA Franchise Systems, Inc. v. Northern Ins. Co. of New York, 32 F.Supp.2d 1254, 1257 (D.Kan. 1998) (stating that under Kansas law an insurer must show substantial prejudice from the lack of notice before it may be relieved of liability); Weaver v. State Farm Mut. Auto. Ins., 936 S.W.2d 818, 821 (Mo. 1997) (holding that under Missouri law an insurer must show substantial prejudice from the lack of notice before it may be relieved of liability). Ostrager & Thomas R. Newman point out that normally the prejudice requirement in the direct insurer context should apply a fortiori in the reinsurance context.

Additionally there is a trend, exemplified by decisions in the influential New York federal and state courts, in which courts have held that, even where the direct insurance jurisprudence presumes prejudice upon late notice (as in New York), in the reinsurance context the Reinsurer must nevertheless prove prejudice before it can be relieved of its responsibilities. See Unigard Sec. Ins. Co., Inc. v. North River Ins. Co., 4 F.3d 1049, 1067-69 (2d Cir. 1993); Christiania General Ins. Corp. of New York v. Great American Ins. Co., 979 F.2d 268, 274 (2d Cir. 1992); Unigard Security Ins. Co., Inc. v. North River Ins. Co., 79 N.Y.2d 576, 582, 584 N.Y.S.2d 290, 594 N.E.2d 571 (1992).

b. Some Courts Have Held The Ceding Insurer to a Higher Standard and Have Not Required Prejudice.

A New Jersey Federal district court recently predicted that under New Jersey law, despite the prejudice requirement in the direct insurance context, the prejudice rule would not be applied to reinsurance context and declined to do so. The Court held:

> The policy behind New Jersey's rule requiring prejudice in late notice claims is to protect the interests of policyholders because insurance

> contracts are contracts of adhesion and policyholders should not lose the benefits of coverage unless the delay has prejudiced the insurance company.
>
> Reinsurance contracts, unlike primary insurance contracts, are not contracts of adhesion. Rather, reinsurance involves two sophisticated business entities familiar with the business of reinsurance who bargain at arms-length for the terms in their contract. Accordingly, BICC cannot argue that the policy behind the prejudice rule applies to reinsurance contracts.
>
> Moreover, in addition to not being a contract of adhesion, another distinction is that a contract of reinsurance is really not a contract of insurance as much as it is a contract of indemnity. Therefore, there is no reason to extend to reinsurance contracts the rule that insurance policies should be construed most strictly against the insurance company.
>
> Accordingly, absent any indication by the New Jersey Supreme Court that the prejudice requirement in late notice cases extends to the reinsurance context or that the same rules of construction that apply to insurance contracts apply to reinsurance contracts, this Court declines to add terms to the Facultative Reinsurance that were not expressly negotiated or bargained for by the parties.

British Ins. Co. of Cayman v. Safety Nat. Cas. Corp. 146 F.Supp.2d 585, 592 -594 (D.N.J. 2001) (internal quotations and citations omitted); see also Liberty Mutual v. Gibbs, 773 F.2d 15, 18 (1st Cir. 1985) (noting that reasons for imposing prejudice requirement in late notice cases did not apply to reinsurance contracts involving experienced insurance underwriters who bargain at arm's length).

c. Conclusion: *REINSURER* Will Likely Be Required to Prove Prejudice.

Despite the logic in the British Ins. Co. of Cayman decision, the trend seems to be that reinsurers are required to prove prejudice from late notice. It is therefore likely that *REINSURER* will be required to prove it was prejudiced by *INSURER's* late notice.

2. **What Constitutes Prejudice In the Reinsurance Context?**

There is no clear standard for what constitutes prejudice in the reinsurance notice context. Some jurisdictions hold that the loss of the right to "associate" with the ceding insurer in the defense and control of the underlying claim or suit constitutes "prejudice." See Keehn v. Excess Ins. Co. of Am., 129 F.2d 503, 505 (7th Cir. 1942) (applying Illinois law to hold that deprivation of the right to associate

constitutes prejudice without any proof that results of litigation would have been different); Stuyvesant Ins. Co. v. United Public Ins. Co., 221 N.E.2d 358, 362 (Ind.App. 1966) (eight-month delay in giving notice prejudiced reinsurer's right to assist and negotiate fair settlement).

Other jurisdictions have held that loss of the right to associate constitutes "prejudice" only if the reinsurer can prove that it would have exercised its right and that would have resulted in a more favorable result. See Fortress Re Inc. v. Central Nat'l Ins. Co., 766 F.2d 163, 166-67 (4th Cir. 1985); Ins. Co. of State of Pennsylvania v. Assoc. Int'l Ins. Co., 922 F.2d 516, 524 (9th Cir. 1991); *INSURER* Ins. Co. v. Cen. Nat'l Ins. Co., 733 F. Supp. 522, 530 (D. Conn. 1990) (reinsurer could not prove prejudice from late notice where it lacked facilities or personnel to investigate or defend claims and where it failed to take any action after receiving notice of claim).

Other jurisdictions require proof of "tangible economic injury" resulting from the late notice. See Unigard, 4 F.3d at 1068. At least one court has found that prejudice could be established if a reinsurer could prove that the late notice caused it to be underreserved or if it impaired a reinsurer's ability to recover from its retrocessionares. Ins. Co. of Ireland Ltd. v. Mead Reins. Corp., 1994 WL 605987, *8 (S.D.N.Y. 1994) (denying summary judgment on the grounds that these were factual issues).

CONCLUSION

Unigard and Constitution Re constitute persuasive authority to support *REINSURER*'s denial of coverage based on *INSURER*'s inadequate and late notice. *REINSURER* should expect, however, that it will have to prove it was prejudiced, preferably in some tangible economic form, before it can be relieved of its obligations under the contract.