UBERRIMAE FIDEI: CONTRACTING WITH THE UTMOST GOOD FAITH

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Born of British maritime insurance law centuries ago, the doctrine of *uberrimae fidei* or "utmost good faith" has in recent decades come to take on specialized application in the context of reinsurance. This evolution has left courts grappling with such issues as whether the duty is a basis for an independent cause of action, a tool of construction applicable to contract actions, or an equitable remedy supporting rescission. An understanding of the nature and history of the doctrine and its evolution in the context of reinsurance is helpful, both from the standpoint of contract negotiation, drafting and claims administration, as well as in the context of reinsurance arbitration and litigation. The relative lack of uniformity in the application of *uberrimae fidei* in the reinsurance context leaves much room for debate and, perhaps more optimistically, creativity.

Black's Law Dictionary notes, in its definition of "*contract uberrimae fidei*"

> [i]n a certain restricted group of contracts good faith is peculiarly necessary owing to the relationship between the parties, and in these cases – known as contracts *uberrimae fidei* – there is a full duty to disclose material facts. The typical instance of such contracts is the contract of insurance. Here the duty to disclose all material facts to the insurer arises from the fact that many of the relevant circumstances are within the exclusive knowledge of one party, and it would be impossible for the insurer to obtain the facts necessary for him to make a proper calculation of the risk he is asked to assume without this knowledge.[1]

The rule was first recognized in 1766 by Lord Mansfield,[2] and was thereafter codified into English maritime insurance law in 1906.[3] The rule was incorporated into American

[1] BLACK'S LAW DICTIONARY, at 320 (7th Ed.) (citation omitted).

[2] A singular subject of study himself, Lord Mansfield, a Scot, rose through the ranks of the English bar, where he retired as Chief Justice of England in 1788. As one biographical synopsis notes "Mansfield has always been recognized as the founder of commercial law. The common law as it existed before his time was wholly inadequate to cope with the new cases and customs that rose with the increasing development of commerce. He defined almost every principle that governed commercial transactions in such a manner that his successors had only to apply the rules he had laid down. His work in bringing the older law into harmony with the needs of modern society has long been fully recognized." See *Medallions and Inscriptions, Lord Mansfield* (at http://www.law.upenn.edu/about/history/medallions/mansfield/index.html) (last visited November 9, 2010).

maritime insurance law by the United States Supreme Court, which noted that, "[t]he contract of insurance, is one of mutual good faith; and the principles which govern it, are those of an enlightened moral policy. The underwriter must be presumed to act upon the belief, that the party procuring insurance, is not, at the time, in possession of any fact material to the risk, which he does not disclose."[4] "The roots of the *uberrimae fidei* doctrine, then, are deeply embedded in American law, having had almost 200 years to take hold."[5]

Traditionally, the reinsurance industry was viewed as having similarities to traditional marine insurance, which explains the evolution of the doctrine of utmost good faith into that arena. Reinsurance is, by necessity, an international market, and, as with marine insurance contracts, knowledge of the risk is peculiarly within the purview of the cedent, who is better positioned to know the factors involved with the risk necessary to calculate losses from an actuarial standpoint, and to investigate them when they occur.[6] These and other factors led to the application of the doctrine in the reinsurance context:

> In respect to the duty of disclosing all material facts, the case of reinsurance does not differ from that of an original insurance. The obligation in both cases is one *uberrimae fidei*. The duty of communication, indeed, is independent of the intention, and is violated by the fact of concealment even where there is no design to deceive. The exaction of information in some instances may be greater in a case of reinsurance than as between the parties to an original insurance.[7]

The doctrine thereafter became embedded in the traditional reinsurance relationship. As one commentator noted, "[t]he absence of utmost good faith within the reinsurance market could spawn increased costs as reinsurers are forced either to hire their own investigative teams to verify and thus to duplicate the assessment of the risk by the ceding insurers, or to increase premiums to cover the greater risk. Reinsurers and ceding insurers have depended on the

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[3] *Certain Underwriters at Lloyds, London v. Inlet Fisheries Inc.*, 518 F.3d 645, 650 (9th Cir. 2008).

[4] *McLanahan v. Universal Ins. Co.*, 26 U.S. 170, 176, 7 L. Ed. 98 (1828).

[5] *Inlet Fisheries, supra*, 518 F. 3d at 650.

[6] See, e.g., Thomas, Steven W., UTMOST GOOD FAITH IN REINSURANCE: A TRADITION IN NEED OF ADJUSTMENT, 41 DUKE L. J. 1548, 1556 – 57 (1992).

[7] *Sun Mut. Ins. Co. v. Ocean Ins. Co.*, 107 U.S. 485, 510, 1 S.Ct. 582 (1883).

principle of utmost good faith to check the abuse inherent in this relationship and to prevent wasted duplication of effort that would result in higher premiums."[8]

However, as with many aspects of the property-casualty insurance industry, things began to change in the 1980's and thereafter, as the crush of long-tail exposures to asbestos and environmental torts began to tax the relationships between parties to both insurance and reinsurance contracts.[9] Courts thereafter began to re-evaluate the manner of application of the doctrine in the reinsurance context.

Emblematic of the state of flux regarding *uberrimae fidei* in the reinsurance context are decisions from the Second Circuit in the early 1990's. In one case, the Court was viewed by some to have left the door open to extra-contractual damages arising from a breach of the duty of utmost good faith: "[a]lthough we find no error in the conclusions that the [defendant] Domestic Reinsurers failed to act in 'utmost good faith' . . . it does not necessarily follow that the Domestic Reinsurers' conduct is, in essence, sanctionable. Thus, the district court's award of fees. . . relies on factual determinations that are not in the record and that this Court is not empowered to make."[10] In another decision the same year, the same Court noted "some have argued that utmost good faith does not accurately describe the modern relationship of sophisticated insurers bargaining at arms length. . . Nevertheless, because information regarding risks lies with the ceding insurer, the reinsurance market depends upon a high level of good faith to ensure prompt and full disclosure."[11] Yet the foregoing decisions were presumably informed by a decision from the same Court only a year earlier that appeared to throw cold water on the concept of an independent cause of action for breach of the duty of utmost good faith, in a case alleging failure by the cedent to provide timely notice of claims:

> At most, a reinsured's failure to provide prompt notice may entitle the reinsurer to relief without showing prejudice if the reinsured acted in bad faith. . . . As to whether the information provided its

[8] Thomas, *supra*, at 1557-58 (citations omitted).

[9] *Id*. at 1559 (noting that these "claims that tap reinsurance policies [ ] were written thirty to forty years ago and were not designed to deal with contemporary concepts of liability. The environmental liability (most often occupational or site cleanup losses) for a single risk can be in the hundreds of millions of dollars and can affect policies written over a number of years, even decades. These losses tap reinsurance policies at a level never anticipated. Because of the sheer quantities of money involved, the interpretation of policies and of ceding insurers' and reinsurers' duties can affect the very survival of an insurance company.").

[10] *Mentor Ins. Co. (U.K.) Ltd. v. Brannkasse*, 996 F.2d 506, 521 (2d Cir. 1993).

[11] *Unigard Sec. Ins. Co., Inc. v. North River Ins. Co.*, 4 F.3d 1049, 1066 (2d Cir. 1993).

> reinsurers demonstrates a 'lack of candor' and therefore a breach of [defendant]'s duty to act in utmost good faith, this is more usefully analyzed under the rubric of whether defendant satisfied its obligation to provide notice that was sufficient to fulfill the purposes for which reinsurers require notice. . . [A]ny such derelictions may be remedied under traditional contract principles concerning substantial compliance and material breaches, without the necessity of asking whether any "lack of candor" amounted to a breach of a duty independent of the contract itself.[12]

It is little wonder then, that courts continue to struggle with these concepts. Shortly after this spate of difficult-to-synthesize appellate guidance, one district court in the Second Circuit allowed an independent cause of action based on breach of the duty of utmost good faith to proceed. "[Plaintiff reinsurer] claims that the conduct of the defendant violates the duty of utmost good faith, independent of the terms of the contract. [The Plaintiff] has advanced a colorable legal argument for such a cause of action and has made sufficient factual allegations to support the claim."[13]

The struggle to apply the doctrine in the context of modern reinsurance relationships continues. Courts have employed creative approaches to the issues. A recent federal district court decision in New York approached the doctrine as a matter of equitable remedy, rather than a cause of action at law unto itself: "the proper remedy for the defendants' breach of the duty of utmost good faith is a declaratory judgment that the policy is voidable *ab initio* at the plaintiffs' instance."[14] Though styled as a declaratory judgment, the decision accords with the traditional rule that a breach of the duty of utmost good faith is a basis for rescission. A recent Illinois federal court decision deemed the duty of utmost good faith to be merely "a tool of construction in deciding whether a party has breached the governing reinsurance treaties. . . . Courts regularly dismiss causes of action for breach of duty of good faith when they are not asserted *within* a breach of contract claim."[15]

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[12] *Christiania General Ins. Corp. of New York v. Great American Ins. Co.*, 979 F.2d 268, 280 - 81 (2d Cir. 1992) (citations omitted).

[13] *See e.g. Arkwright Mut. Ins. Co. v. National Union Fire Ins. Co. of Pittsburgh, PA.*, No. 90 Civ. 7811 (AGS), 1995 WL 3006, *4 (S.D.N.Y. Jan. 4, 1995).

[14] *American Home Assur. Co. v. Masters' Ships Management S.A.*, 423 F. Supp. 2d 193, 224 (S.D.N.Y. 2006), *aff'd.*, 489 F.3d 497 (2d Cir. 2007).

[15] *Guarantee Trust Life Ins. v. Insurers Administrative Corp.*, No. 09-5129, 2010 WL 3834026, *3 (N.D. Ill. Sept. 24, 2010).

Complicating matters, the doctrine still enjoys vitality in the context of primary marine insurance, though the issues raised in that context do not necessarily translate to the modern reinsurance relationship, which has been transformed in recent decades as some of the bases for the origination of the doctrine have been rendered obsolete. When the doctrine was developed centuries ago, "insureds were considered morally obligated to disclose all information material to the risk the insurer was asked to shoulder, but such a principle was also an economic necessity where insurers had no reasonable means of obtaining this information efficiently, without the ubiquity of telephones, email, digital photography, and air travel."[16] Now, many parties may have nearly instantaneous access to much material information, but there may be other highly material information that remains within the exclusive knowledge and control of one party.

There are colorable bases and legal precedent going both ways as pertains to enforcement of the duty as an independent cause of action, even potentially opening the door to extra-contractual damages. However, the differences in the nature of the modern reinsurance relationship – the equal bargaining power of the parties, the technology of information sharing, and a shrinking globe – provide support for the view that the doctrine's relevance in the context of reinsurance may be diminishing. There may also be important differences in application of the rule from one jurisdiction to another that should be kept in mind at the contracting stage, where choice of law provisions are considered, as well as in litigation and arbitration.

Nevertheless, despite the uncertainty that surrounds the doctrine and its manner of application, its history provides clues as to what contracting parties in the reinsurance context can expect. As the doctrines of 'follow the fortunes' and 'follow the settlements' still bind reinsurers to the coverage decisions and claims assessments of their cedents, the duty of utmost good faith balances the scales by placing a heightened duty of disclosure on the cedent of all information material to the risk undertaken by the reinsurer.

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[16] *Inlet Fisheries Inc., supra,* 518 F.3d at 646.