

# The Bad Faith Exception to the Prejudice Requirement Does Not Represent New York Law

By Syed S. Ahmad and Patrick M. McDermott

The early 1990s spawned several notable reinsurance rulings by courts. Some of those decisions, which have been in the spotlight recently, relate to the applicability of reinsurance limits.<sup>1</sup> Another category relates to reinsurers' late-notice defenses. In particular, the New York Court of Appeals ruled in 1992 that, unlike direct insurers, reinsurers must show prejudice resulting from alleged late notice.

In subsequent decisions in 1993, the Second Circuit made certain statements—since relied on by reinsurers—to argue that they actually need not show prejudice if they meet a purported

bad faith exception to prejudice. The oft-cited example is establishing that a cedent lacked practices and procedures to ensure notice to reinsurers. Just like it recently did with the decisions regarding reinsurance limits,<sup>2</sup> the Court of Appeals should rein in the case law about the purported bad faith exception to the prejudice requirement.

This bad faith exception was highlighted in the last issue of the *Quarterly* in an article titled “No Harm, No Foul: Jury Rejects Reinsurer’s Late-Notice Defense.”<sup>3</sup> In that article, the authors reviewed the recent jury verdict and related court decision in *Utica Mutual*

*Insurance Company v. Fireman’s Fund Insurance Company*.<sup>4</sup> Utica ultimately prevailed in that suit, and the court entered judgment for \$64.1 million in damages and pre-judgment interest. Yet Utica still had to overcome Fireman’s Fund’s defense that, under the alleged bad faith exception, it need not show prejudice resulting from alleged late notice simply because, according to Fireman’s Fund, Utica lacked practices and procedures to ensure notice to reinsurers.

## No Basis in New York Law

Utica should not have been required to do so. The purported bad faith excep-



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tion to the prejudice requirement stems from a series of decisions in a dispute between Unigard Security Insurance and North River Insurance and a subsequent decision involving Christiania General Insurance and Great American Insurance. As discussed below, a close examination of those decisions reveals that the exception arises out of dicta and has no basis in, and is inconsistent with, New York law.

**The Second Circuit’s First Unigard Decision (*Unigard I*).** In *Unigard I*, the reinsurer (Unigard) asserted that the cedent (North River) provided late notice of certain underlying claims. The district court found that North River provided notice late, but rejected Unigard’s late-notice defense after concluding that Unigard had not shown that the late notice caused prejudice.

On appeal, the Second Circuit Court of Appeals found “no New York appellate court decision addressing the question of whether a reinsurer must prove that it was prejudiced by untimely notice of loss in order to successfully invoke a late-notice defense.”<sup>5</sup> Thus, the court certified a question to the New York Court of Appeals, asking: “Must a reinsurer prove prejudice before it can successfully invoke the defense of late notice of loss by the reinsured?”<sup>6</sup>

**The New York Court of Appeals’ Unigard Decision (*Unigard II*).** The New York Court of Appeals—the state of New York’s highest court—answered that question affirmatively. The Court of Appeals recognized that New York did not require direct insurers to show prejudice resulting from late notice,<sup>7</sup> but emphasized that there were “significant and basic differences between primary insurance and reinsurance.”<sup>8</sup> Thus, the court held “that this ‘no prejudice rule’ does not apply

to a failure to comply with the prompt notice requirement in a contract of reinsurance.”<sup>9</sup> In its ruling, the court created no exception to its holding that “the reinsurer must demonstrate how [late notice] was prejudicial . . .”<sup>10</sup>

**The Second Circuit’s Christiania Decision.** The *Unigard* case then went back to the Second Circuit. While the case was under consideration, the Second Circuit decided *Christiania*, another reinsurance case involving late-notice allegations.<sup>11</sup> In *Christiania*, the court reviewed a lower court’s decision on late notice in a section titled “I. Notice.”

The Second Circuit reversed the district court’s decision on that issue, finding a question of fact about when notice was due.<sup>12</sup> In its ruling, the Second Circuit acknowledged the New York Court of Appeals’ *Unigard* decision requiring reinsurers to show prejudice resulting from the cedent’s late notice. The ruling further stated that the reinsurer (*Christiania*) might be able to demonstrate prejudice on remand.<sup>13</sup>

In a different section titled “III. Other Claims,” the Second Circuit evaluated *Christiania*’s claim that the cedent breached “its duty to deal in utmost good faith by virtue of its conscious decision not to provide notice sooner.”<sup>14</sup> The court found this claim “difficult to understand” because “the significance of defendant’s ‘conscious,’ or knowing decision not to provide notice sooner is not explained by *Christiania*.”<sup>15</sup> According to the court, if the cedent “should have provided notice earlier than it did—whether its failure was conscious or otherwise—then the ‘prompt notice’ requirement has not been satisfied.”<sup>16</sup> Under that scenario, the court noted, *Christiania* still would

have had to establish prejudice.<sup>17</sup>

Significantly, the Second Circuit then rejected a notion similar to the purported bad faith exception to the prejudice requirement. “It seems that what *Christiania* would have us do is supplant the New York rule that a reinsurer must prove prejudice as a result of late notice by holding that ‘consciously’ late notice, without more, is sufficient to entitle the reinsurer to relief. We reject this invitation.”<sup>18</sup> That is, the court held that the reinsurer could not avoid showing prejudice by establishing that the cedent consciously provided late notice. Thus, the court affirmed the dismissal of the reinsurer’s claim that the cedent breached its duty of utmost good faith.<sup>19</sup>

Despite that, the court stated, in dicta, that “[a]t 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.”<sup>20</sup> Even in qualified dicta, this was an unusual statement given that in the separate section dealing with the reinsurer’s late-notice defense, the court had already acknowledged the Court of Appeals’ requirement that the reinsurer show prejudice.

Moreover, as a New York state court recognized, “to the extent that *Christiania* relied on New York law [with respect to the bad faith exception to prejudice], its citations were not in the reinsurance context or in the context of notice.”<sup>21</sup> Rather, the two New York cases the *Christiania* court cited involved “primary insurers placing their interests above those of excess insurers.”<sup>22</sup> The court’s reliance on those direct insurance cases is particularly strange because the New York Court of Appeals’ ruling that reinsurers must show prejudice resulting from late

notice was based in part on the differences between direct insurance and reinsurance.<sup>23</sup>

In sum, *Christiania* did not hold that a reinsurer may avoid showing prejudice resulting from late notice if it can show that a cedent acted in bad faith with respect to notice. Rather, it held that a reinsurer could not avoid showing prejudice even if the cedent consciously withheld notice.

The qualified statement in *Christiania* that reinsurers might be able to avoid showing prejudice if they establish that their cedent acted in bad faith does not represent New York law for four reasons:

First, it is contrary to the Court of Appeals' ruling in *Unigard II*. In that decision, the court held that reinsurers must show prejudice and identified no exception to that requirement.

Second, the *Christiania* court's actual ruling was that a reinsurer must show prejudice even if the cedent consciously withheld notice. Thus, the dicta that bad faith "may" excuse a reinsurer from showing prejudice is inconsistent with the *Christiania* court's actual decision, which would *require* a reinsurer to show prejudice even where the cedent consciously withheld notice.

Third, the New York case law cited by *Christiania* does not support the statement. Those cases dealt with direct insurance, not reinsurance. The Court of Appeals' ruling in *Unigard II* that reinsurers must show prejudice was based on the "significant and basic differences between primary insurance and reinsurance."<sup>24</sup> Therefore, cases about direct insurance cannot support an exception to the reinsurance-specific rule that reinsurers must show prejudice.

Fourth, even ignoring the problems

above, the statement is dicta. Dicta is not binding.<sup>25</sup>

### **The Second Circuit's Second Unigard Decision (*Unigard III*)**

Following the *Christiania* decision, the Second Circuit issued its decision in *Unigard III*. The court began by reviewing the New York Court of Appeals' answer to the certified question. It stated that "we certified to the New York Court of Appeals the question whether a reinsurer must prove prejudice to prevail on a late loss notice defense. The Court of Appeals held that prejudice must be shown."<sup>26</sup> Then, applying the New York Court of Appeals' ruling, the Second Circuit found that Unigard could not establish prejudice resulting from North River's late notice.<sup>27</sup>

Nevertheless, the court cited the *Christiania* court's statement that "a [ceding insurer's] failure to provide prompt notice may entitle the reinsurer to relief without showing prejudice if [the ceding insurer] acted in bad faith."<sup>28</sup> Notably, the Second Circuit cited no authority other than *Christiania* to support this proposition. As shown above, *Christiania's* actual holding was to the contrary, and the cited statement is inconsistent with New York law.<sup>29</sup>

The Second Circuit appears to have raised this bad faith issue because the lower court had stated that "North River might have violated the duty of utmost good faith if it inadvertently failed to disclose material information to its reinsurer."<sup>30</sup> The Second Circuit rejected that statement because, rather than inadvertence, "the proper minimum standard for bad faith should be gross negligence or recklessness."<sup>31</sup>

The *Unigard III* court then went even

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further than the dicta in *Christiania*, stating that if a cedent "does not implement" "routine practices and controls to ensure notification to reinsurers," the cedent "has willfully disregarded the risk to reinsurers and is guilty of gross negligence." The court cited no authority, much less New York law, supporting this dicta.

Ultimately, the Second Circuit did not even apply its "gross negligence or recklessness" bad faith standard, instead concluding that because there was "no intent to deceive Unigard," the cedent did not act in bad faith.<sup>32</sup>

**Subsequent Court Decisions**

After *Unigard* and *Christiania*, one court assumed, without analysis, that the bad faith exception to the prejudice requirement constituted New York law.<sup>33</sup> The court in *Utica v. Fireman's Fund* also invoked the bad faith exception and actually addressed the issues raised above, but was unwilling to find that the dicta in *Christiania* and *Unigard* did not represent New York law.<sup>34</sup> Thus, at trial, Utica had to and did disprove Fireman's Fund's unsupported assertion that Utica lacked practices and procedures to notify reinsurers.<sup>35</sup>

A New York state case, however, has recognized that the bad faith exception to the prejudice requirement "has not been implemented by the courts of this state [i.e., New York]" and that the New York law cited by *Christiania* to support that exception involved direct insurance, not reinsurance.<sup>36</sup> When that decision was appealed, the intermediate New York appellate court did not reject those statements; instead, it remanded for a determination of whether the reinsurer has suffered prejudice as a result of late notice.<sup>37</sup>

**Conclusion**

In *Unigard II*, the Court of Appeals held unequivocally that "the reinsurer must demonstrate how [late notice] was prejudicial."<sup>38</sup> The Second Circuit's statements in *Christiania* and *Unigard III* regarding a purported bad faith exception to that unequivocal rule do not represent New York law because (1) they are contrary to *Unigard II*, (2) they are unsupported by New York law, (3) they were not even applied in those decisions, and (4) they are dicta.

Some federal courts, however, have relied on those statements as if they are New York law. Accordingly, it appears

that the New York Court of Appeals needs to rule on this issue, as was the case with the federal courts' continuous misinterpretation of *Bellefonte* and *Unigard III*.

**NOTES**

1. See, e.g., Amy S. Kline et al., *Global Domination? What's Left of the Bellefonte Rule After Global Reinsurance Corp. of America v. Century Indemnity Co.?*, *ARIAS•U.S. Quarterly*, Q1, 2018, at 9.
2. *Bellefonte Reinsurance Co. v. Aetna Casualty & Surety Co.*, 903 F.2d 910 (2d Cir. 1990); *Unigard Sec. Insurance Co. v. N. River Insurance Co.*, 4 F.3d 1049 (2d Cir. 1993).
3. Tancred V. Schiavoni III & Vincent Weisband, *No Harm, No Foul: Jury Rejects Reinsurer's Late-Notice Defense*, *ARIAS•U.S. Quarterly*, Q3, 2018, at 6.
4. *Utica Mutual Insurance Co. v. Fireman's Fund Insurance Co.*, 287 F. Supp. 3d 163 (N.D.N.Y. 2018).
5. *Unigard Sec. Insurance Co. v. North River Insurance Co.*, 949 F.2d 630, 631 (2d Cir. 1991).
6. *Id.* at 632.
7. *Unigard Sec. Insurance Co., Inc. v. North River Insurance Co.*, 594 N.E.2d 571, 574 (N.Y. 1992).
8. *Id.*
9. *Id.* at 571.
10. *Id.* at 575.
11. *Christiania Gen. Insurance Corp. of N.Y. v. Great American Insurance Co.*, 979 F.2d 268 (2d Cir. 1992).
12. *Id.* at 277-78.
13. *Id.* at 274.
14. *Id.* at 280.
15. *Id.* at 281.
16. *Id.*
17. *Id.* at 274.
18. *Id.* at 281.
19. *Id.*
20. *Id.* (emphasis added).
21. *New Hampshire Insurance Co. v. Clearwater Insurance Co.*, No. 653547/2011, 2013 NY Slip Op 32812(U), at \*8-9 (N.Y. Sup. Ct. Nov. 1, 2013). The non-New York decision relied upon by the *Christiania* court applied North Carolina law. See *Fortress Re, Inc. v. Cent. National Insurance Co. of Omaha*, 766 F.2d 163, 165-66 (4th Cir. 1985).
22. *Id.* at \*8-9 (citing *St. Paul Fire & Marine Insurance Co. v. U.S. Fid. & Guar. Co.*, 375 N.E.2d 733, 733 (N.Y. 1978) (finding that record adequately supported finding that primary insurer breached obligation owed to excess insurer "to manage its insureds' defense in good faith"); *Hartford Accident & Indemnity Co. v. Mich. Mutual Insurance Co.*, 93 A.D.2d 337, 342 (N.Y. App. Div. 1983) (finding that primary insurer breached duty owed to excess insurer "to exercise good faith in handling the defense and to safeguard the rights and interest of the excess carrier" by not proceeding against particular third-party defendant).
23. *Unigard*, 594 N.E.2d at 574-75.
24. *Id.*
25. See *New Shows, S.A. de C.V. v. Don King Prods., Inc.*, 1999 WL 553780, at \*11 n.12 (S.D.N.Y. July 29, 1999) (jury need not decide party's contractual right to attorneys' fees notwithstanding Second Circuit's statement to the contrary because the "statement was dicta, and need not be followed"), *aff'd*, 210 F.3d 355 (2d Cir. 2000); *New York v. U.S. Army Corps of Engineers*, 896 F. Supp. 2d 180,

- 196 (E.D.N.Y. 2012) (because language in Supreme Court decision was dicta, the court "need not follow it"); *United States v. Gotti*, 413 F. Supp. 2d 287, 292 (S.D.N.Y. 2005) (problem with reliance on excerpt from Second Circuit decision was that the "passage is dicta and, as such, does not have binding precedential value"), *aff'd*, 166 F. App'x 517 (2d Cir. 2006).
26. *Unigard Sec. Insurance Co. v. North River Insurance Co.*, 4 F.3d 1049, 1053 (2d Cir. 1993).
27. *Id.* at 1067-69.
28. *Id.* at 1069 (alteration in original) (quoting *Christiania*, 979 F.2d at 281).
29. See *Unigard*, 594 N.E.2d at 575 (holding that "the reinsurer must demonstrate how [late notice] was prejudicial"); *New Hampshire Insurance*, 2013 NY Slip Op 32812(U), at \*8-9 (recognizing that *Christiania* did not rely on New York reinsurance law).
30. *Unigard*, 4 F.3d at 1069 (citing district court opinion).
31. *Id.*
32. *Id.* at 1069-70 (emphasis added).
33. *Granite State Insurance Co. v. Clearwater Insurance Co.*, 2014 WL 1285507, at \*21-22 (S.D.N.Y. Mar. 31, 2014).
34. *Utica Mutual Insurance Co. v. Fireman's Fund Insurance Co.*, 2015 WL 521024 (N.D.N.Y. Feb. 9, 2015). The authors represented Utica in connection with the motion that led to that decision.
35. According to the authors of the "No Harm, No Foul" article, Utica prevailed on that issue because it had provided evidence "on the supposed effectiveness and implementation of" its reporting policies and because "Utica had a reporting process (however flawed) ...." Tancred V. Schiavoni III & Vincent Weisband, "No Harm, No Foul: Jury Rejects Reinsurer's Late-Notice Defense," *ARIAS•U.S. Quarterly*, Q3, 2018, at 6, 8. In fact, the alleged late notice to Fireman's Fund resulted from missing certificates and Utica provided notice immediately upon locating the certificates. Thus, any late notice had nothing to do with Utica's policies and procedures for providing notice to reinsurers. In any case, based on Utica's reporting procedures, Utica provided "early notice to over a dozen facultative reinsurers that Utica was aware of before notice was due." *Utica Mut. Insurance Co. v. Fireman's Fund Insurance Co.*, 287 F. Supp. 3d 163, 173 (N.D.N.Y. 2018). The sole bases for Fireman's Fund's claim that Utica somehow acted in bad faith were that Utica's document retention policies in the 1960s and 1970s (before the advent of asbestos and environmental claims) and that Utica did not locate certain primary insurance policies. Neither of those had anything to do with policies for providing notice. These circumstances show how far reinsurers can try to expand a purported requirement that cedents have policies for providing notice or risk letting their reinsurers off the hook for late notice without any resulting prejudice.
36. *New Hampshire Insurance*, 2013 NY Slip Op 32812(U), at \*8-9.
37. *New Hampshire Insurance Co. v. Clearwater Insurance Co.*, 129 A.D.3d 99, 117-18 (N.Y. App. Div. 2015).
38. 594 N.E.2d at 575.