

Reinsurance Litigants May Need to Avoid Putting Their Faith in the Tort of Bad Faith

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Reinsurance Alert

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In a recent Alabama federal court decision, aptly captioned *Alabama Municipal Insurance Corporation v. Munich Reinsurance American, Inc.*,^[1] the plaintiff reinsured brought three counts of bad faith against the defendant reinsurer for failing to pay several claims totaling \$1.9 million. The court granted the reinsurer's motion to dismiss the bad faith counts concluding that Alabama does not recognize the tort of bad faith in the reinsurance context.

Because the Alabama Supreme Court had never addressed bad faith with respect to reinsurance agreements, the district court was tasked with making an "educated guess" as to what rule the Alabama Supreme Court would adopt. Given the Supreme Court's record of consistently limiting the application of bad faith to protect vulnerable consumers, the court predicted that the Supreme Court would not extend it to reinsurance.

The court explained that the tort of bad faith was created to address the "inherently unbalanced" relationship between an insurance company and its policyholder. In short, the tort of bad faith was designed to "restore balance in the contractual relationship" given that consumers are unable to negotiate the terms of the average insurance policy, leaving the insurer in a "superior bargaining position."

The court found that the same underlying policy considerations do not exist in the reinsurance context because reinsurers and reinsureds are both sophisticated companies that generally enter contract negotiations on equal footing. Thus, unlike a typical policyholder, both the reinsured and reinsurer have bargaining power, access to legal counsel, and a deep understanding of the intricacies at play in reinsurance contracts. Due to these factors, the court concluded that the Alabama Supreme Court would not expand the scope of the tort of bad faith to encompass reinsurance contracts.

Courts in other jurisdictions have also weighed in on this issue. The *Alabama Municipal Insurance Corporation* court borrowed extensively from a 2008 California decision, *California Joint Powers Insurance Authority v. Munich Reinsurance America, Inc.*^[2] Similar to *Alabama Municipal Insurance Corporation*, the California Supreme Court provided no controlling authority on bad faith tort liability in reinsurance. But the state's prior decisions in non-reinsurance cases guided the federal court towards a narrow approach. California courts traditionally held that an insurer's breach of the covenant of good faith and fair dealing is a violation of social policy, justifying tort damages. But as business-savvy commercial entities, the elements of contractual adhesion and unequal bargaining power are not at play between a reinsurer and reinsured. Therefore, the court concluded, the public policy rationale supporting tort recovery in California was not present in the reinsurance setting.

A federal court in Pennsylvania has reached the same conclusion finding that a statutory bad faith claim is not available in reinsurance actions. In the matter of *Gaffner Insurance Company v. Discover Reinsurance Company*,^[3] the Middle District of Pennsylvania expressly held that bad faith pursuant to 42 Pa.C.S. § 8371 does not apply to reinsurance agreements. The court explained that the aforementioned statute was intended to protect consumers from insurance companies, not "two sophisticated, bargaining parties from one another."

Other courts have reached the opposite conclusion. In *Commercial Union Insurance Company v. Seven Provinces Insurance Company*,^[4] the District of Massachusetts held that the reinsurer, Seven Provinces, was liable for a claim under Mass. Gen Laws Ch. 93(a) – a statute that “allows one business to sue another over conduct that is ‘unfair’” even where the unfair acts are associated with breach of a contract. In evaluating whether a 93A claim could be made against Seven Provinces, the court noted that “while mere breaches of contract, without more, do not violate chapter 93A,” a 93A claim can arise out of a breach of contract, “if the breach is ‘in disregard of known contractual arrangements’ and ‘intended to secure benefits for the breaching party.’” The court, holding that Commercial Union had proven a 93A claim against Seven Provinces, found that Seven Provinces “withheld performance due under the [reinsurance] contract in order to renegotiate the bargain between the parties.”

While there is not a great deal of case law addressing the viability of a claim for bad faith in the reinsurance context, the majority of courts that have addressed the issue have focused on the public policy concerns underlying the tort – namely, the unequal bargaining power between insurers and policyholders. As those same public policy concerns are not present with respect to reinsurance agreements negotiated between sophisticated companies, these courts have refused to recognize the tort of bad faith in the reinsurance context. Courts that have reached the opposite result, like in Massachusetts, have not focused on public policy concerns like unequal bargaining power but rather the overall “unfairness” of the company’s actions and whether those actions rose to such a level to warrant bad faith liability. Of course, many reinsurance disputes are resolved in arbitration, and a panel of reinsurance industry experts may have their own views on whether the tort of bad faith (as opposed to a breach of the inherent duty of good faith and fair dealing) is viable in reinsurance.

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[1] 2021 U.S. Dist. LEXIS 49112 (M.D. Ala. 2021)

[2] 2008 U.S. Dist. LEXIS 56654 (C.D. Cal. 2008)

[3] 2007 U.S. Dist. LEXIS 75259 (M.D. Pa. 2007)

[4] 9 F. Supp. 2d 49 (D. Mass. 1998)

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