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Reinsurance Implications of Politically Expanded COVID-19 Coverage

by John M. O'Bryan and Thomas F. Bush

A FREEBORN & PETERS LLP CLIENT ALERT

In the wake of the COVID-19 pandemic, there has been a tremendous amount of discussion and debate about the extent to which commercial insurance policies will compensate businesses for some of their losses. In particular, some practitioners and politicians have argued that business interruption (BI) coverage under existing commercial property policies should cover some of the massive losses being suffered by businesses across the United States. This Alert details what that could mean for reinsurers and cedents.

Depending on policy language, insurers may assert contractual defenses to COVID-19 BI claims, including: (i) the risk of COVID-19 contamination, even if supported by evidence of infection by building occupants, does not qualify as physical damage to covered property, (ii) BI resulting from a government-ordered shutdown does not qualify as property damage, and (iii) policy exclusions for loss caused by a virus or bacteria foreclose coverage. Inevitably, insurers' invocation of these contractual defenses will run up against strong political headwinds.

For example, a bipartisan group of congressional representatives is pressing commercial property insurers to accept coverage for BI losses arising from the pandemic. This pressure from legislators is likely to grow as BI losses mount and the November elections approach.

Other lawmakers are introducing legislation that will require insurers to provide BI coverage. New Jersey legislators have introduced a bill that would retroactively rewrite certain policies to expressly cover business interruption caused by the pandemic (while allowing affected insurers to seek reimbursement from the state, with such reimbursements funded via additional assessments on insurers). Other state and local legislatures may take a more subtle approach, such as declaring buildings uninhabitable due to damage caused by COVID-19 and/or characterizing COVID-19 in a way that avoids most virus exclusions, similar to the way several affected states declared Sandy to not be a hurricane so as to avoid the hurricane deductible in many property policies. Obviously, such efforts, to the extent they result in new laws or rules, are susceptible to legal challenge.

But what is certain is that property insurers will be under significant pressure to accept coverage even when there are valid policy and legal defenses thereto. In some instances, direct insurers may find it better business to accede to political demands and simply pay BI claims rather than contest coverage and thereby engender the enmity of politicians and state insurance departments, not to mention judges and juries potentially sympathetic to struggling policyholders. Reinsurers should anticipate cessions of such BI loss payments.

What can reinsurers do when they receive such cessions? Most reinsurance treaties contain "follow the fortunes/follow the settlements" clauses that generally prohibit the reinsurer from second guessing the cedent's good faith claims handling settlements with policyholders.

However, these clauses typically require the reinsurer to pay only claims that could reasonably be construed as falling within a reinsured policy's coverage terms. Extra-contractual/*ex gratia* payments generally are not reinsured absent express treaty language providing such coverage. The sort of *ex gratia* payments that fall outside the scope of reinsurance coverage may be payments of BI claims not covered under the terms of its policy that a cedent made in order to stay in the good graces of, or avoid criticism from, government officials.

It is also important to note that many reinsurance treaties have arbitration clauses that contain "honorable engagement" language, which are variants of the following:

> The arbitrators shall interpret this Contract as an honorable engagement and not as merely a legal obligation. They are relieved of all judicial formalities and may abstain from following the strict rules of law. They shall make their award with a view to effecting the general purpose of this Contract in a reasonable manner rather than in accordance with a literal interpretation of the language.

Some treaties also direct arbitrators to construe the treaties from a "practical business" vantage. Reinsurers can expect cedents to invoke such clauses when they seek to recover for claims paid under political pressure. Cedents may argue that, with the unprecedented impact of COVID-19, the "general purpose" of reinsurance treaties is that reinsurers share industry-wide political risks to the same extent as cedents. Applying such a "follow the political pressures" notion, cedents may ask arbitration panels to apply a general commercial reasonableness standard to their claims handling irrespective of policy terms, and then argue that it would have been commercially unreasonable for the cedents to deny the BI claims in light of the COVID-19 catastrophe. Such an argument would be novel, but these are novel times, and this is a novel virus. Of course, whether such an argument would gain traction will depend upon many variables, such as the particular language of the policy and treaty at issue, the handling of the claim, the political climate, the composition of the arbitration panel, and how this pandemic plays out.

The *ex gratia* payment issue gets even more complicated if governmental bodies do more than just pressure insurers to voluntarily pay uncovered claims. Cedents can be expected to contend that a payment compelled by legislation is not *ex gratia*. However, a reinsurer may respond that the issue remains whether the claim falls reasonably within the reinsurance coverage, and the cedent's liability arises not from the terms of the reinsured policy but from legislation. Further issues will arise if the legislation provides, as the proposed New Jersey law does, for reimbursement of the cedent and possibly funding of the reimbursement by special assessments on all property insurers. Is the reinsurer's liability for a loss reduced by the amount of the reimbursement received by the cedent? Do the amounts the cedent pays as assessments constitute a reinsured loss?

In the event that an insurance department adopts a new regulation, or a state legislature passes a new statute, with the effect of *creating* COVID-19 BI coverage in existing policies, insurers must decide whether they will challenge the new regulation/law in court, and if so, how and to what extent. The contracts clause in the U.S. Constitution, prohibiting states from passing a law "impairing the Obligation of Contracts," provides cedents a basis for such a challenge.

In light of these developments that could significantly affect a reinsurer's obligations, reinsurers may be well advised to insist on timely, continuing, and detailed notification of developments from their cedents, as well as to consider exercising their right to associate in the defense of claims. Strategic decisions will need to be weighed if there are statutes or regulations that could alter the scope of insurance coverage. A reinsurance treaty would not necessarily be rewritten by such changes in laws or regulations. But a reinsurer may need to decide whether it is more expedient to join with a cooperative cedent in challenging such laws or regulations on the front end, or instead to leave the handling of claims entirely to the cedent while reserving rights regarding reinsurance coverage until the cedent reaches a final resolution of the claim. For a variety of reasons, reinsurers are often reluctant to engage with their cedents in the underlying claims handling, but these exceptional times may justify more active engagement between cedents and reinsurers.

If you have questions, please contact John O'Bryan and Thomas Bush and stay tuned for more developments on Freeborn's COVID-19 webpage.

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