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The Case for Transparency: Why the Courts Should Find a "Common Interest" Between Cedent and Reinsurer

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The relationship between a ceding company and its reinsurer requires close cooperation and mutual trust. The reinsurer is almost entirely dependent upon the ceding company for information concerning the risk that is the subject of the reinsurance. The ceding company, in turn, relies upon the reinsurer to fairly and promptly pay claims in accordance with the reinsurance contract between them. In light of case law in certain jurisdictions, however, there has been an erosion of this relationship as ceding companies have begun to withhold information that has historically been made available to reinsurers. Without sufficient information to adequately assess the legitimacy of those claims, reinsurers are reluctant to promptly pay claims and more likely to contest claims. This situation is not sustainable and the courts that are responsible for the current state of affairs need to rethink their view of the relationship between a ceding company and its reinsurer. Specifically, cedents and reinsurers must attempt to focus the courts' attention on public policy considerations that are at odds with the judicial opinions giving rise to this problem.

At the heart of this problem is the explosion of mass tort litigation. Policyholders in coverage disputes with their insurers are seeking to discover information relating to their insurer's reinsurance coverage. These policyholders are seeking to discover not only the details of the reinsurance relationship, but also any and all documents that their insurer has provided to its reinsurer in the course of the reinsurance relationship, including otherwise privileged materials (e.g., exposure analyses, defense assessments by coverage counsel, and reserve recommendations, to name a few). Policyholders have argued, with some success, that insurers waive their right to assert a claim of privilege on any documents that have been disclosed to their reinsurers. Although the majority of courts find that an insurance company and its reinsurer have a "common interest" such that the parties may share privileged information while still maintaining their expectation of confidentiality vis-à-vis third parties, a few courts have held to the contrary. Moreover, a majority of courts have refused to find a "common interest" when the issue has arisen in the context of a reinsurer trying to obtain disclosure of the privileged documents in the first instance. There is absolutely no justification for this distinction. Courts declining to find a "common interest" in either context fail to appreciate the significance of the duties and obligations that distinguish a reinsurance relationship from other contractual business relationships. It is these duties and obligations – among them the duty of utmost good faith and the follow the settlements doctrine – that justify application of the common interest doctrine even where other business relationships might fall short.

The Common Interest Doctrine

Although the precise elements of the attorney-client privilege vary from state to state, it is generally accepted that confidential communications between an attorney and her client conducted for the purpose of securing or rendering legal assistance are privileged against disclosure. In addition, the work product doctrine provides that material may be protected from disclosure if it is prepared by or for a party in preparation for trial if it contains or discloses the mental impressions, conclusions, opinions, or legal theories of the party's attorney. These protections are not, however, absolute. In most circumstances, the voluntary delivery of a privileged communication to one who is not a party to the privilege vitiates or "waives" the privilege.

There are certain situations, however, in which disclosure may occur without constituting a waiver of the privilege. One such situation is where the parties in question share a "common interest." The common interest doctrine generally holds that a party may share privileged documents with another party with whom it shares a "common interest," while still maintaining the ability to assert the privilege as against other third-parties. The communications are privileged vis-à-vis third parties, but are not privileged in a subsequent controversy between the original disclosing parties. *(See 8 J. Wigmore, Evidence § 2312 (1961)).* Unfortunately, there is little uniformity in how the common interest doctrine is applied by the courts. Thus, it is often difficult to predict whether parties will be found to posses the requisite "common interest."

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In its original formulation, the common interest doctrine applied in situations where two parties shared a common attorney. *(See 8 J. Wigmore, Evidence § 2312 (1961)).* A number of courts have, however, expanded the "common interest" doctrine to include situations where parties represented by separate counsel engage in a common legal enterprise – the so called "joint defense privilege." Other courts have further expanded the doctrine to include communications between entities that have parallel interests but are not actively pursuing a common legal strategy. The seminal case expanding the "common interest" doctrine in this manner is *Duplan Corp. v. Deering Milliken, Inc.* [2] In *Duplan,* the court held that "a community of interest exists among different persons or separate corporations where they have an identical legal interest with respect to the subject matter of a communication between an attorney and a client concerning legal advice." According to the *Duplan* court, "[t]he key consideration is that the nature of the interest be identical, not similar, and be legal, not solely commercial."

The courts have struggled with how to apply the common interest doctrine in the context of the relationship between a ceding company and its reinsurer. There are courts that have employed a quite limited view of the common interest doctrine and have refused to find a "common interest" in the context of a reinsurance relationship. In *Allendale Mutual Insurance Co. v. Bull Data Systems, Inc.,* [3] for example, a federal district court stated, albeit in dicta, that a cedent's disclosure of privileged information to a reinsurer waives any privilege that might have applied to the information. According to the *Allendale* court, the "common interest" doctrine is limited to situations where clients face "a common litigation opponent." The *Allendale* court concluded that the documents sought by the policyholder in the case before it were all created in the "ordinary course of business" and therefore that "*Allendale* waived any privileges that might have existed when, in the ordinary course of business, it disclosed the information contained in the documents to its reinsurers."

The majority of courts, however, find to the contrary and have rejected attempts by policyholders to argue that the disclosure of privileged information to a reinsurer results in the waiver of the privilege. These courts find a clear "common interest" between a ceding company and its reinsurer. Thus, in *Durham Industries, Inc. v. North River Insurance Co.,* [4] a federal district court refused to permit a policyholder to obtain discovery of information that had been shared between the ceding company and its reinsurer, holding that "where the reinsurers bear a percentage of liability… their interest is clearly identical to that of [the ceding company]." Similarly, in *Pfizer Inc. v. Employers Insurance. Co. of Wausau,* [5] a New Jersey court relied on the principles of the common interest doctrine (while not specifically referring to the doctrine by name) in declaring that the insurer did not waive the attorney-client privilege by sharing otherwise privileged communications with its reinsurers. The special master in *Pfizer* held that "[t]he interests of the parties to the communications have qualitatively identical interests in the eventual outcome, and it would not be socially useful for the law to require production of their communications transmitted during the litigation itself and concerning the litigation." The special master noted that "[i]t is natural that an insurer should keep its reinsurers abreast of events in coverage litigation." To find that the insurer had nevertheless waived privilege would "discourage candor, and stifle a flow of helpful and legitimate information which has value only if the parties to the communications can rely on confidentiality."

Although the majority of courts endorse application of the common interest doctrine in the context of what courts and commentators have labeled the "defensive" use of the doctrine, i.e., an effort to prevent the disclosure of privileged documents to a policyholder, the majority of courts have rejected application of the common interest doctrine in the "offensive" context, i.e., an effort by a reinsurer to compel production of privileged documents from the insurance company. In other words, the majority of courts have declined to find that reinsurers have a legal right to obtain disclosure of privileged documents based on the reinsurers' "common interest" with the insurance company.

For example, in *North River Insurance Co. v. Philadelphia Reinsurance Corp,* [6] a federal district court denied a reinsurer's motion for production of privileged materials from the insurer's underlying coverage dispute with its policyholder. The court found that "the common interest

[2] 397 F. Supp. 1146, 1172 (D.S.C. 1974).

[3] 152 F.R.D. 132 (N.D. Ill. 1993).

[4] No. 79 Civ. 1705, 1980 WL 112701, *3 (S.D.N.Y. Nov. 21, 1980).

[5] No. C-108-92 (N.J. Super., Middlesex Co.), available in Vol. 8 Mealey's Lit. Rep. Reinsurance No. 20 (Feb. 25, 1998).

[6] 797 F. Supp. 363, 367 (D.N.J. 1992).

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doctrine is completely unlashed from its moorings in traditional privilege law when it is held broadly to apply in contexts other than where there is dual representation." Similarly, in *North River Insurance Co. v. Columbia Casualty Co,* [7] another federal district court, in a suit to recover defense costs allegedly due under a reinsurance contract, rejected the reinsurer's argument that it was entitled to documents from an underlying ADR proceeding that would otherwise be privileged because it shared a "common interest" in the proceedings with the cedent. In granting the cedent's motion for a protective order, the *Columbia* court explained, "[w]hat is important is not whether the parties theoretically share similar interests but rather whether they demonstrate actual cooperation toward a common legal goal." The court further held that "[t]his rationale applies with even greater force in the reinsurance context," since the reinsurer does not have a duty to defend that would at least imply some level of cooperation in the litigation. Accordingly, the Columbia court found that there was no common interest between the parties because (1) they were not represented by the same counsel [in the ADR proceedings], (2) the reinsurer did not contribute to its cedent's legal expenses, (3) the reinsurer did not exercise any control over the cedent's conduct of the proceedings, (4) the parties did not coordinate litigation strategy in any way, and (5) the parties' legal interests sometimes diverged as demonstrated by the instant litigation.

At least one case in the analogous insurance coverage context has, however, held to the contrary. In *Waste Mangement, Inc. v. International Surplus Lines Insurance Co.,* [8] the Illinois Supreme Court held that even when the insured hired its own lawyer in the underlying case and was engaged in coverage litigation against its insurers, the insured still maintained a "common interest" with the insurance company. Accordingly, the court held that the attorney-client privilege and work-product doctrines did not bar disclosure of the defense counsel's files to the insurer. The court found the "common interest" of the insured and its insurer in minimizing the liability to the third-party plaintiffs sufficient to warrant production of the privileged documents to the insurer.

The Cedent-Reinsurer Relationship

As the cases demonstrate, there is little consensus among the courts addressing these issues. One thing that is clear, however, to anyone who is familiar with the rights and obligations of ceding companies and reinsurers is that the courts that have refused to extend the common interest doctrine to the reinsurance relationship – whether to prevent disclosure to a policyholder *or* to require disclosure to a reinsurer – fail to comprehend the nature of the relationship between a ceding company and its reinsurer.

The reinsurance relationship is marked by certain customs and practices that distinguish the connection between a ceding company and its reinsurer from other business relationships. Principal among those customs and practices is the duty of "utmost good faith," which requires each party to the reinsurance contract to provide a full and timely disclosure to the other party. For the ceding company, that means providing all known information concerning the risks that are the subject of the reinsurance contract and providing a full and timely notice of every claim. As explained by one court:

> *Reinsurance works only if the sums of reinsurance premiums are less than the original insurance premium. Otherwise, the ceding insurers will not reinsure. For the reinsurance premiums to be less, reinsurers cannot duplicate the costly but necessary efforts of the primary insurer in evaluating risks and handling claims. Reinsurers may thus not have actuarial expertise, or actively participate in defending ordinary claims. They are protected, however, by a large area of common interest with ceding insurers and by the tradition of utmost good faith, particularly in the sharing of information.*

Unigard Security Insurance Co. v. North River Insurance Co. [9] Characterizing the ceding insurer and the reinsurer as "joint venturers," the *Unigard* court emphasized the importance of the ceding insurer providing the reinsurer with a "prompt and full disclosure" and noted that without that disclosure "reinsurance would become unavailable." [10]

Indeed, the cedent's good faith obligation to provide information is critical given another core component of the reinsurance relationship – the obligation of the reinsurer to "follow the settlements" of the ceding insurer. This obligation, sometimes referred to as the "follow the

[7] No. 90 Civ. 2518 (MJL), 1995 WL 5792 (S.D.N.Y. Jan. 5, 1995).

[8] 579 N.E.2d 322, 327 (Ill. 1991).

[9] 4 F.3d 1049, 1054 (2d Cir. 1993) (citations omitted).

[10] Id. at 1054, 1066; see also Reliastar Life Ins. Co. v. IOA Re, Inc., 303 F.3d 874, 878 (8th Cir. 2002) ("To arrange their business otherwise would result in greatly increased costs for both reinsurance and the underlying policies themselves.").

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fortunes" doctrine, requires the reinsurer to indemnify the cedent for all payments reasonably within the terms of the original policy, even if not technically covered by it. *International Surplus Lines Insurance Co. v. Certain Underwriters at Lloyd's of London.* [11] In other words, the follow the settlements doctrine "requires reinsurers to reimburse the reinsured (or cedent) for payment of the settled claims so long as the payments were made reasonably and in good faith." *Id.* In this manner, the follow the settlements doctrine ensures the transfer of risk from the ceding company to the reinsurer and puts the ceding company in a position where it can comfortably settle and pay claims. As described by the *ISLIC* court:

> *This standard is purposefully low. Were the Court to conduct a de novo review of [the cedent's] decision-making process, the foundation of the cedent-reinsurer relationship would be forever damaged. The goals of maximum coverage and settlement that have been long established would give way to a proliferation of litigation. Cedents faced with de novo review of their claims determinations would ultimately litigate every coverage issue before making any attempt at settlement. Such a consequence this Court will not abide.*

Id.

The follow the settlements doctrine, therefore, serves the important public policy goal of ensuring the fair and timely payment of insurance claims to injured parties. In order for this public policy goal to be met, however, the reinsurer must be in a position to assure itself that claims are being properly managed. Absent an insurer's ability to share information freely with its reinsurer without fear of waiving privilege, the reinsurer may find itself in a position where it is hesitant to pay because it has not been provided with sufficient information to enable it to determine whether a particular claim was reasonably paid or settled. Indeed, without adequate information available, reinsurers may not be willing to underwrite particular policies in the first instance and, if they do, the economic impact on the marketplace could be significant.

For these reasons, the courts need to harmonize their application of privilege law with the follow the settlements doctrine. Courts need to recognize the alignment of the insurer and reinsurer and apply the common interest doctrine in a way that allows the transparency necessary to permit reinsurers to be kept fully informed so that ceding companies can be confident that their reinsurers are behind them if a settlement with an insured seems reasonable. The courts can still protect privilege vis-à-vis policyholders. Indeed, insurers should not have to choose between keeping reinsurers informed and maintaining privilege vis-à-vis their insureds. The strict interpretation of the "common interest" doctrine applied by some courts is in clear tension with the ceding company's obligation to provide information and the reinsurer's need for such information in order to pay claims. The mere fact, emphasized by some courts, that the reinsurer is not a party defendant should be of no significance. Rather, the courts should focus on the fact that the reinsurer will, if the claim is covered by the reinsurance, share in any liability suffered by the insurer. Thus, the reinsurer has a vested interest in the cedent's coverage and litigation decisions.

This same reasoning applies with equal force when a reinsurer seeks to compel the production of privileged documents in the possession of the ceding insurer. To the extent that those documents relate to issues of underwriting or issues relating to the settlement of particular claims, the reinsurer has a right to and a need for these documents. It does not serve the public interest to permit the insurer to rely on the common interest doctrine when avoiding the production of privileged documents to its policyholders but then reject application of the doctrine when the reinsurer is seeking production of the privileged documents in the first instance. The courts denying reinsurers' efforts to obtain such documents wrongly focus on the fact that the insurance company and reinsurer are in an adverse position at the time the request for documents is made. The proper focus is on the relationship of the insurer and the reinsurer at the time the privileged communication was made. In most cases, the reinsurer will have been entirely dependent upon the ceding company's judgment in underwriting the policy or resolving the claim at issue. Therefore, the reinsurer will not have the information needed to make an informed decision about whether a claim is covered by the reinsurance agreement. Indeed, even if the reinsurer was operating under a reservation of rights at the time it sought the privileged information, the insurer would still have been acting on behalf of the reinsurer in underwriting the policy, and investigating and settling the claim. The fact that a subsequent dispute may arise between the insurer and reinsurer does not abrogate the "common interest" and should not affect the court's judgment.

Although courts in the United States have been slow to authorize the "offensive" use of the common interest doctrine, at least one court in the United Kingdom

[11] 868 F.Supp. 917, 921 (S.D. Ohio 1994); see also *Christiania Gen. Ins. Corp. v. Great Am. Ins. Co.*, 979 F.2d 268, 280 (2d Cir. 1992).

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has endorsed this concept, recognizing the relationship between the follow the settlements doctrine and the common interest doctrine. In *Commercial Union Assurance Co. v. Mander,* [12] the court held that a "contract of reinsurance which contains a 'follow [the] settlements' clause does create a community of interest between insurer and reinsurer in the original claim "such that an insurer" cannot withhold from the reinsurers on the ground of privilege documents brought into being for the purposes of handling the original claim, even if they would be subject to legal professional privilege as against a third party." [13] Similar reasoning should be used by courts in the United States when presented with a reinsurer's request to compel the production of privileged documents from its reinsured, even where there is a dispute between the insurer and reinsurer. If the courts are concerned with the potential for waiver as to third-parties, the courts can take steps to ensure that such waiver does not take place. Thus, in a recent case, a federal district court judge granted a reinsurer's motion to compel the production of privileged documents but specifically set forth in his order that the insurer's production of documents "does not constitute a waiver by [the insurance company] of the attorney/client privilege and/or the work product doctrine with respect to those documents." *Travelers Casualty & Surety Co. v. Constitution Reinsurance Corp.* [14]

In sum, those courts that have refused to permit reinsurers access to privileged documents should rethink their view of the relationship between a ceding company and its reinsurer. The same public policy considerations that have led to judicial recognition of the doctrines of utmost good faith and follow the settlements, argue for application of the common interest doctrine in the context of the relationship between a ceding insurer and its reinsurer. The failure to recognize a "common interest" in this context may place a tremendous burden on insurance companies who find themselves facing increased litigation with their reinsurers, more unpaid claims, and higher reinsurance premiums.

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[12] 2 Lloyd's Rep. 640 (June 12, 1996).

[13] The court, however, declined to order production of the documents to the reinsurer because the reinsurer was seeking to rescind the very contract that created the "community of interest" in the first instance.

[14] No. 01-71057 (E.D. Mich. June 13, 2003), available in 14-6 Mealey's Litig. Rep. Reinsurance 3 (July 17, 2003). Although the Travelers court declined to determine whether the insurance company and the reinsurer had a "common interest," as the reinsurer had argued, the court did find that in failing to produce documents relating to the insurer's allocation of a $137 million settlement, the insurance company was "abusing the attorney/client privilege."