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'Reinsurance and COVID-19,' by Larry P. Schiffer

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Reinsurers, like insurers, are assessing their exposure to potential COVID-19 losses. There are, of course, many considerations. These include: (a) whether the loss comes within the terms and conditions of the underlying insurance policy; (b) whether a cedent's loss payments were made on an ex gratia basis; (c) whether civil authority orders change the dynamic; (d) understanding which lines of business are affected; (e) whether reinsurance contracts allow for aggregation of COVID-19 losses as a single occurrence; and, (f) whether a reinsurer has too much COVID-19 concentration. Reinsurers are struggling with issues like maintaining a work force, either on site or remotely, and determining whether reinsurers are essential businesses under the myriad state business closure orders.

One thing is clear, all the issues that insurance companies are facing, both on the life and health side and the property and casualty side, are issues that reinsurers will be examining when receiving claims from cedents. Because the reinsurance industry is the natural financial backstop for the insurance industry, it is critical for reinsurers to continue operations to address the claims as they come in and support their cedents in assessing the myriad insurance issues arising from the COVID-19 pandemic.

This article will focus on issues from the property and casualty perspective, but many of the same issues arise in the life and health context as well.

What Do Reinsurers Do First?

The first thing reinsurers will do is review their assumed portfolio to determine where potential COVID-19 claims are likely to come from. Reinsurance contracts run the gamut from broad quota share and whole

account protections to excess-of-loss contracts on specific lines of business to facultative certificates for specific policies. Reinsurers will need to assess their line of business spread and determine where the concentrations are for possible COVID-19 loss cessions. Once identified, reinsurers have to look at the terms and conditions of the ceded policies.

Because of the massive disruptions happening now with voluntary and mandatory business closures, commercial property reinsurers are watching closely for business interruption, contingent business interruption and supply chain losses arising from COVID-19 shut downs. As thousands, if not millions, of businesses close because of civil authority orders or because of supply chain disruptions, the first tranche of losses that reinsurers might see will be from the business income and extra expense coverages on their assumed property portfolios.

Clearly, this will be a contentious area as already can be seen with the start of coverage litigation between policyholders and insurers over the terms and conditions of business interruption coverage provisions. Reinsurers will be watching (and perhaps assisting where appropriate) as insurance companies and policyholders battle over the meaning of what many in the insurance industry consider clear and unambiguous policy language requiring direct physical loss or damage to property.

Moreover, this issue can blow up completely if state legislatures, or the federal government, intervene and pass laws retroactively directing insurers to provide business interruption coverage in spite of unambiguous exclusions or clear policy language requiring specific triggering activities. More about this later.

What Are Some of the Key Insurance Issues and Exposures?

There are myriad articles on COVID-19 and business interruption from the policyholder perspective and from the insurer perspective discussing many of these issues. Some of the key issues include the requirement of direct physical damage or loss to insured property by covered loss requirements, waiting periods, civil authority orders and exclusions for losses arising from virus and bacteria exposure.

Going beyond business interruption, reinsurers will be looking at directors and officers exposures. There are several securities class action cases pending against cruise lines, and others, because of alleged wrongdoing associated with responding to COVID-19. Reinsurers will also be watching general liability exposures. Here too, passengers who boarded ships after prior passengers disembarked with COVID-19 diagnoses are suing cruise lines. Those passengers are alleging negligence in failing to sanitize and failing to warn subsequent passengers about prior passengers who were later diagnosed with COVID-19.

No doubt, other businesses, including healthcare businesses and governmental entities, will face lawsuits for negligence for failing to warn about COVID-19 exposures, or allowing third parties to come in contact with exposed or contagious employees. Workers compensation insurers, of course, will see an uptick in claims because of “essential” employees who, while working, contract COVID-19 and be out of work for significant periods of time. Disability insurers likely will see an uptick in claims as well. Insurance companies that wrote event cancellation coverage are being inundated with claims.

In other areas, there may be a claims slowdown. For example, less people on the road means less vehicular accidents. Traditional slip and falls in businesses will also lessen as so many businesses are closed. Traditional workplace accidents also should decrease temporarily with the closure of businesses.

Because of the many statewide closure orders, reinsurers will be watching for property exposures from fire, flood and vandalism that may rise because buildings, residences and other property is essentially abandoned. Reinsurers will have to work with their cedents to use technology or other means to make sure closed businesses do not become loss-producing sites. COVID-19 makes this all more difficult because of the closure orders, the need for social distancing, and the loss of employees from either layoffs or illness.

What Are Some of the Key Reinsurance Issues?

No doubt, follow-the-fortunes/follow-the-settlements issues will arise if cedents choose to pay business interruption claims and cede them to their reinsurers. For example, what if a ceding company accepts and pays COVID-19 losses based a determination that the virus is causing direct physical damage to insured property? Is that something that reinsurers will also accept?

The answer to that question depends on various factors. First, the specific reinsurance contract wording is key to determining whether a loss cession is proper. Second, the facts of the underlying loss, and whether that loss fits within the actual terms and conditions of the ceded policy, are critical to determining a reinsurance claim.

A critical point of reinsurance contract wording analysis is whether the reinsurance contract broadly or narrowly defines the ceding company's right to determine the losses ceded to the contract. Does the reinsurance contract have traditional clauses that allow the cedent to determine the loss and require the reinsurer to follow the determination of the cedent? Does the reinsurance contract provide that the cedent is the "sole judge" on determining whether a loss can be ceded?

Modern reinsurance contracts do not all have the traditional follow-the-fortunes or follow-the-settlements clauses or the traditional utmost good faith language that older reinsurance contracts often contained. If the reinsurance contract does not have language requiring the reinsurer to follow the cedent's claims determinations, it is more likely that the cession of a COVID-19 loss under a business interruption cover may be rejected by a reinsurer on the basis that there is no direct physical loss and that COVID-19 is not a covered peril. But, if the reinsurance contract has a more traditional follow-the-settlements clause, does that make a difference?

Cedents will argue that under a traditional follow-the-settlements provision a reinsurer must follow its claims determination and pay the loss. Reinsurers, on the other hand, will argue that the claims determination has to be made in good faith and businesslike to be followed. The traditional principles of follow-the-settlements support the notion that if the cedent pays a claim reasonably and in good faith, and the claim falls within the terms of the underlying contract and the reinsurance contract, the reinsurer must pay, and the reinsured's claims determination will not be second-guessed.

Disputes over cessions of COVID-19 business interruption losses, if they happen, likely will focus on whether the payment was reasonable, made in good faith and comes within the terms of the ceded insurance contract and the reinsurance contract. If the underlying contract has the virus and bacteria exclusion, it will be very hard for a cedent to seek reinsurance coverage for a COVID-19 claim under those circumstances. If the business income and extra expense coverage, as it normally does, requires direct physical damage or loss to covered property by a covered cause of loss, the dispute will come down to whether a virus can cause direct physical damage. But, if these provisions are absent or if the underlying policy covers contagion, the reinsurance response may be different.

This issue will only be exacerbated if legislative intervention directs insurers to pay insureds for business income and extra expense coverage even if a virus and bacteria exclusion exists and even if there is no direct physical damage to property from a covered peril. Even if legislation does not retroactively force insurers to provide coverage, what if regulatory pressure compels cedents to pay claims on a “voluntary” basis that they would not ordinarily have paid? Most reinsurance contracts do not allow for the cession of ex gratia payments. Will reinsurers feel the same market/regulatory pressure to fall in line? Then what happens at the retrocessional level, especially if the retrocessionaires are outside the US?

Another significant issue that reinsurers may face is the prospect of COVID-19 losses being aggregated as one event or one occurrence under property catastrophe or other reinsurance contracts that contemplate aggregation of losses. This complex issue depends on the reinsurance contract wording and especially the definitions used for the aggregation language. A critical review of aggregation language will prepare reinsurers for potential cessions of COVID-19 losses as one event.

Conclusion

The COVID-19 pandemic is not unlike other disasters the insurance industry has faced in the past. No doubt, the reinsurance industry will respond appropriately. That response, however, will be consistent with the reinsurance contract wording and commensurate with the premium charged for the reinsurance. While reinsurance is the backstop for the insurance industry, it is not the backstop for the country. While the insurance industry is financially strong and able to weather this event, expecting insurance and reinsurance to solve all problems, even those not covered by clear and unambiguous policy wording, is unwarranted.

As the underlying coverage issues play out, reinsurers will be prepared to respond accordingly.

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