

# Declaratory Judgment Expenses: The Issue that Just Won't Go Away

Thomas Klemm  
Funk & Bolton, P.A.

The scenario is all too familiar in the reinsurance industry. An insured, facing millions of dollars in tort liability, files a declaratory judgment action ("DJ") to determine whether its insurer is obligated to indemnify and defend the insured. In some cases, the insurer itself files the DJ to determine the issue. In either event, the stakes are usually high. Failure at this stage (either failure in raising the DJ or failure in defending it) could subject the insurer to incredible indemnity obligations; success could save the insurer from such costs. The insurer often commits significant resources to the DJ. Although insurers win some and lose some, most cases are settled before judgment is rendered. In any of these scenarios, the legal expenses incurred defending or prosecuting the DJ are often submitted to reinsurers for reimbursement often giving rise to disagreements on whether the reinsurer is obligated to reimburse the insurer for such expenses. Although more recent contracts may specifically address this issue, the issue remains a topic of hot debate under thousands of reinsurance contracts written before DJs were as common and costly as they have become.<sup>2</sup>

## I. The Arguments

The arguments from both sides are well known. From the ceding company's perspective, actions taken and positions asserted in a DJ typically benefit the ceding company and its reinsurers. A preemptive DJ filed by the insurer may also provide further advantages.<sup>3</sup> Surely, ceding companies argue, equity and principles of utmost good faith demand reinsurers to pay, because if the insurer had prevailed, the reinsurer would have benefited. Likewise, reinsurers benefit to the extent that the ceding company obtains favorable settlement by litigating coverage.

The reinsurers counter that they are in the business of reinsurance - that is, reinsuring specific risks covered by their reinsurance contracts. DJ expenses are not the traditional defense costs covered by reinsurance agreements (e.g. expenses related to the insurer's investigation or defense of a claim against the insured), but a normal business expense insurance companies incur as part of the cost of doing business (i.e., overhead). As such, reinsurers argue that DJ expenses are not covered by reinsurance agreements.

## II. The Cases

Although arbitrators have been dealing with the issue of DJ expenses for years, often producing varied results,<sup>4</sup> relatively few court cases have addressed the issue. Due to the relatively sparse case law, the few cases addressing the issue provide valuable insight and warrant close scrutiny.

In the oldest, and perhaps most influential case, *Affiliated FM Ins. Co. v. Constitution Reins. Corp.*,<sup>5</sup> the insured sought a declaration that its insurer owed a duty of defense and indemnity regarding a series of employment discrimination claims. The court found in favor of the insurer, and a later appellate court affirmed the decision. After these direct insurance decisions were rendered, the ceding company billed its reinsurer for its share of the related DJ expenses. The reinsurer objected to the DJ expense billing claiming that such expenses were not covered by the reinsurance contract. In the litigation that followed, the trial court granted summary judgment in favor of the reinsurer. The case was then appealed.

During the appeal, the ceding company argued that "commentators have spoken with one voice" on the DJ expense issue and that they "uniformly have concluded that the reinsurer is contractually obligated" to indemnify the ceding company.<sup>6</sup> Finding

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Tom Klemm is an associate in Funk & Bolton's Reinsurance Practice Group, headquartered in the firm's Philadelphia office.

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these sources were “not dispositive” and that there was no “case law addressing this issue directly,” the court turned to the language of the reinsurance contract.<sup>7</sup> The court focused specifically on the certificate language which covered “expenses [other than office expenses and payments to any salaried employee] incurred by the [insurer] in the investigation and settlement of claims or suits. . . .”<sup>8</sup> Finding the word “expenses” ambiguous, the court admitted extrinsic evidence to determine the ambiguity.<sup>9</sup> The trial court was presented with “evidence of [the reinsurer's] practice” in dealing with DJ expense issues. Remanding the case, however, the appellate court held that “evidence of custom and trade practice” also would be admissible and persuasive evidence regarding the ambiguity issue.<sup>10</sup> On remand, the jury found in favor of the ceding company.

The most important aspect of the *Affiliated FM* case is probably not the jury verdict requiring the payment of DJ expenses, but instead the court's ruling to admit extrinsic evidence regarding custom and practice to interpret the contract language. While the appellate court emphasizes that the decision was based on the ambiguous nature of the contract, it is unclear whether the finding of ambiguity was, in fact, critical (i.e., would the court have reviewed extrinsic evidence even upon concluding the contract was unambiguous?). Courts often feel compelled to find ambiguity because, as a general rule, extrinsic evidence is not admissible to interpret an unambiguous contract. Courts and scholars have been wrestling with this issue for decades. Segments of *Affiliated FM* highlight these complexities. Indeed, the appellate court's language clearly implies that ambiguity is required before admitting extrinsic evidence:

“Where, as here, the contract language is ambiguous, evidence of trade usage is admissible to determine the meaning of the agreement.”<sup>11</sup>

“Where, as here, the contract language is ambiguous, evidence of custom and trade practice may be admitted to arrive at an interpretation . . . .”<sup>12</sup>

The appellate court, however, also cites a quotation to the Restatement of Contracts

noting that “[t]here is no requirement that an agreement be ambiguous before evidence of usage or trade can be shown . . . .”<sup>13</sup> Thus, it is not entirely clear whether ambiguity was a condition precedent to the admission of this kind of evidence.

Though debate continues, extrinsic evidence generally cannot be admitted to contradict an unambiguous document, but it can be utilized in the initial determination of whether a document is ambiguous. As one scholar notes, “[i]n determining whether contract language is ambiguous, a court is not limited to the face of the contract itself” and it “may look at the circumstances surrounding the making of the contract and at any relevant usage of trade, course of dealing, and course of performance. . . .”<sup>14</sup> This conceptually difficult premise might best explain why the *Affiliated FM* court seemed eager to simply declare the language ambiguous - since all courts and scholars agree extrinsic evidence can be used to interpret an ambiguous contract. No clear consensus exists on whether trade usage and custom is admissible in determining whether a contract is ambiguous.

Given that the court in *Affiliated FM* focused on the specific language in the contract, it is not entirely surprising that a court construing different contract language would reach an entirely different result. Finding no ambiguity existed under facultative certificates issued by a reinsurer, the Second Circuit in *British Int'l Ins. Co. Ltd. v. Seguros La Republica, S.A.* granted summary judgment in favor of the reinsurer, holding that it was not liable for DJ expenses.<sup>15</sup> Unlike *Affiliated FM*, the certificates at issue were silent as respect expenses. Instead, each certificate stated only that “[t]his Certificate of Reinsurance is subject to the same risks valuations, conditions, [and] endorsements . . . as are or may be assumed, made or adopted by the by the reinsured, and loss, if any, hereunder is payable pro rata with the reinsured . . . .”<sup>16</sup> Distinguishing *Affiliated FM* based on specific contract language, the Second Circuit held the contract language was unambiguous and did not require the reinsurer to pay DJ expenses.

A close reading of the case reveals that the discrepancy between *Affiliated FM* and *British Int'l Ins.* may not have been so much a lack of ambiguity in *British Int'l Ins.*, but how that lack of ambiguity was presented. The

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court appeared troubled by the fact that the insurer simply pronounced the language as being “so broad” that it is “impossible to interpret without resort to industry custom.”<sup>17</sup> As the court stated, a “party relying on ambiguity is normally obligated to show that a word, phrase, or provision could suggest more than one meaning.”<sup>18</sup> Here, the insurer did “not propose multiple meanings” and thus the court was “not persuaded that this argument sufficiently establishes an ambiguity . . . .”<sup>19</sup> While the ceding company in *Affiliated FM* “articulate[d] multiple meanings that the contract language will sustain,” the ceding company in *British Int’l Ins.* did not.<sup>20</sup>

In *British Int’l Ins.*, the cedent argued that “even in the absence of ambiguity” regarding the reinsurance contract “industry custom and practice may be used to supplement the terms expressed in the contract.”<sup>21</sup> Even though the cedent did “not formulate the circumstances in which a term may be thus implied, or why this case requires that result” the court concluded the “record evidence of custom and practice” was “insufficient to raise the legal issue.”<sup>22</sup> In other words, there was no evidence that any specific custom or practice existed or that either party was aware of it. As the court stated, the cedent’s evidence failed to prove that the “omitted term is fixed and invariable” in the reinsurance industry, and it also failed to “establish either that the party sought to be bound was aware of the custom, or that the custom’s existence was so notorious that it should have been aware of it.”<sup>23</sup>

The cedent’s follow the fortunes argument was similarly rejected. The court ruled that the doctrine had no application since the DJ expenses did not involve a risk insured by the underlying insurance policies. Instead, “invocation of the doctrine required a showing that [the ceding company’s] own declaratory judgment expense in litigating against its policyholders is potentially within the coverage of the underlying policies;” and, as the court stated, this could “not be done.”<sup>24</sup>

It is important to note that although

the *British Int’l Ins.* and *Affiliated FM* courts reached different conclusions, they applied the same basic analytical process to resolve the issue. As the two cases show, courts focus first and foremost on the specific contract language to determine whether there is any ambiguity. If there is no ambiguity, then the court likely will decide the issue as a matter of law. If, however, an ambiguity is found, then the court may allow extrinsic evidence to address the ambiguity. A court’s ruling as respects ambiguity or the lack thereof, however, does not guarantee a specific result on the merits. In other words, finding an ambiguity exists does not mean the ceding company will prevail. Conversely, the absence of an ambiguity does not ensure judgment in the reinsurer’s favor.

Indeed, two federal district courts have held that the unambiguous expense provisions in reinsurance contracts unambiguously required the payment of DJ expenses. In *Employers Reinsurance Corp. v. Mid-Continent Casualty Co.*, the contract language obligated the reinsurer to reimburse the ceding company’s “claim expenses.”<sup>25</sup> This definition, based on a supplementary provision, included “all expenses which [the ceding company] incurs with respect to any claim it investigates.”<sup>26</sup> Noting this contract language was “more expansive” than that found in *Affiliated FM*, the *Employers Reinsurance* court ruled that “a plain reading” of the contract language “indicates that it covers [the ceding company’s] declaratory judgment fees and expenses.”<sup>27</sup>

A similar result occurred in *Employers Ins. Co. of Wausau v. American Re-Insurance Co.*<sup>28</sup> The contract at issue stated that: “[t]he Reinsurer shall be liable for its proportion of allocated loss expenses. . . .”<sup>29</sup> The term “allocated loss expense” was defined to include “all expenses incurred in the investigation and settlement of claims or suits. . . .”<sup>30</sup> The court ruled that such language encompassed “expenses incurred in declaratory judgment actions attempting to avoid coverage for a claim.”<sup>31</sup> Due to the unambiguous nature of the contract, there was “no question” that the reinsurer was obligated to pay DJ expenses.<sup>32</sup>

In a more recent decision, the federal district court in California relied upon extrinsic evidence to interpret ambiguous contract language. In *Fireman’s Fund Ins. Co. v. General Reinsurance Corp.*, the court held that the reinsurer was obligated to pay DJ expenses and ruled in the ceding company’s favor.<sup>33</sup> In this case, the ceding company, Fireman’s Fund, issued five insurance policies to a series of chemical/oil companies. Gen Re, in turn, reinsured these policies under five facultative certificates.

Each of the insureds became involved in substantial pollution and/or asbestos claims, and each company eventually initiated a DJ against Fireman’s Fund to determine coverage. In these proceedings, Fireman’s Fund incurred substantial expenses, and it ceded a portion of these costs to Gen Re. These claims were rejected and a lawsuit commenced.

Each reinsurance certificate obligated Gen Re to pay its “its proportion of expenses . . . incurred by [the ceding company] in the investigation and settlement of claims or suits. . . .”<sup>34</sup> Fireman’s Fund presented evidence that “DJ expenses were routinely and knowingly paid by reinsurers,” including Gen Re.<sup>35</sup> Gen Re challenged this claim and argued that Fireman’s Fund’s evidence was based on the practice of a single company and thus did not qualify as evidence of industry practice or custom.<sup>36</sup> Gen Re further suggested that “even if DJ expenses were routinely paid by reinsurers, payment of those expenses was not knowing.”<sup>37</sup>

Finding the Gen Re certificate language to be “virtually identical to the language” in *Affiliated FM*, the court relied upon *Affiliated FM* and held the term “expenses” was ambiguous. For this reason, the court allowed extrinsic evidence to be introduced to determine the parties’ intent.<sup>38</sup> William J. Gilmartin proved to be Fireman’s Fund star witness - and the key to the court’s decision. According to Mr. Gilmartin’s testimony, which the court deemed “highly credible,” between the 1960’s and 1980’s reinsurers reimbursed cedents for

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payment of DJ expenses as a matter of custom and practice.<sup>39</sup> Based on this testimony, and evidence that Gen Re had routinely paid DJ expenses, the court found that at the time of the certificates' issuance "there was a nearly universal custom and practice in the reinsurance industry of paying DJ expenses under certificates containing language substantially the same or similar to the language contained in the Certificates here."<sup>40</sup>

The pivotal nature of Mr. Gilmartin's testimony is particularly significant because he was a witness on the losing side in *British Int'l Ins.*<sup>41</sup> The *Fireman's Fund* court determined that, along with finding the contract language unambiguous (i.e., not requiring the review of industry custom and practice), the *British Int'l Ins. court* found Gilmartin's testimony regarding industry practice "unpersuasive."<sup>42</sup> In the *British Int'l Ins.* case, there were several flaws. First, Mr. Gilmartin "did not aver" that "reinsurers always and invariably" paid DJ expenses. Instead, his testimony "can be read" as saying that payments of DJ expenses "were made ex gratia when reinsurers believed that the coverage litigations advanced their common interest, but not otherwise."<sup>43</sup> Thus, it does represent an invariable practice. Second, Mr. Gilmartin failed to testify that "the language contained in the reinsurance certificates issued by other reinsurers was similar to the language in the certificates at issue in that case."<sup>44</sup> As such, it could not be said that a given custom or practice applied to the contractual language at issue. Third, there was "no allegation of actual or constructive knowledge on the part of the reinsurer or evidence that the practice was so notorious in the industry that the reinsurer must have been aware of it."<sup>45</sup>

In *Fireman's Fund*, all of these deficiencies were overcome. Mr. Gilmartin's testimony could not "reasonably be read to say that reinsurers only paid DJ expenses when it suited their interest."<sup>46</sup> Likewise, in this case, Mr. Gilmartin "clearly stated that his opinion concerning the custom and practice of other reinsurers is based on his experience regarding payment of DJ expenses under facultative reinsurance certificates containing the same or similar language to that at issue here."<sup>47</sup> This testimony was based on an entire understanding of the reinsurance industry and not just one company - the court had previously stated

that Mr. Gilmartin was not only aware of the custom and practice of CNA's reinsurance department (where he was employed) "but also of the reinsurers to which CNA ceded risk, including Gen Re."<sup>48</sup> Finally, the evidence suggested that Mr. Gilmartin "never encountered a single instance in which DJ expenses were denied under similar language . . ."<sup>49</sup> This was "sufficient to establish constructive knowledge based on a notorious custom and usage in the industry."<sup>50</sup>

The *Fireman's Fund* court had other ways to distinguish *British Int'l Ins.* The court explained that the language in the certificates in *British Int'l Ins.* was "significantly different" from the language here.<sup>51</sup> Indeed, the *British Int'l Ins. court* had distinguished itself from the earlier *Affiliated FM* decision (which, as mentioned, had language almost identical to that in *Fireman's Fund*). Unlike the ambiguous "expenses" language found in *Affiliated FM* and *Fireman's Fund*, the *British Int'l Ins. court* interpreted a clause which made no reference whatsoever to "expenses."<sup>52</sup> Thus, the *Fireman's Fund court* found *British Int'l Ins.* inapplicable and distinguishable.<sup>53</sup>

Gen Re's only real counter argument was quickly brushed aside. It argued that reinsurers around the world were unaware of the "custom and usage" regarding DJ expenses, and as such this evidence should not be considered.<sup>54</sup> The court disagreed noting that reinsurers had both constructive and actual knowledge of the custom and usage. The court explained that, "[w]here a custom and usage is essentially universal, as the evidence shows it was here, a party is presumed to have knowledge of it."<sup>55</sup> It further stated that it "simply is not credible that reinsurers were unaware for decades that they were paying DJ expenses along with their share of the loss . . ."<sup>56</sup>

### III. Will the Issue Ever Go Away?

For those keeping score (and lawyers always keep score!), the court decisions (including the recent *Fireman's Fund* decision) are four to one in favor of the cedents. The recent decisions arguably reflect a trend in that direction. The court's broad, sweeping statements in *Fireman's Fund* regarding coverage of DJ expenses under reinsurance contracts will no doubt feature prominently in future arguments by cedents. These

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statements, however, must be viewed in the context of the specific contract language at issue. Again, the lesson to be learned from all of the reported court decisions is that contract language matters.

The case law, however, is only part of the story. Since most reinsurance disputes are decided in confidential arbitrations and those decisions typically never see the light of day, there are no doubt countless numbers of DJ expense decisions that cannot be adequately analyzed. Even where anecdotal evidence of arbitration results emerge, it is difficult to know how or why a particular arbitration panel reached the result it did. Further, it is not uncommon for the DJ expense issue to be one of several issues and maybe even the least important (in terms of the actual dollar amount involved).

In these undisclosed opinions there is no way to determine the extent to which arbitration panels are influenced by case law. Indeed, some court decisions are widely considered “wrong” by industry insiders and are routinely ignored by arbitrators. Parties and their counsel, however, are well advised not to ignore the case law regarding DJ expenses - particularly those decisions in which the courts have undertaken a lengthy, detailed analysis of the issue.

In the end, reinsurers that dispute any obligations to pay DJ expenses are unlikely to change their minds - irrespective of the developing case law or arbitration results. While many reinsurers may acknowledge liability for DJ expenses, in situations where their contracts contain expense provisions similar to those involved in the cases discussed above, and where the parties fail to compromise on the issue, it appears that the issue is not going away any time soon. ▼

1 Tom Klemm is an associate in Funk & Bolton's Reinsurance Practice Group. He is currently licensed to practice law in Maryland and the District of Columbia. The Reinsurance Practice Group is headquartered in the firm's Philadelphia office at 1717 Arch Street, Suite 4600, Philadelphia, PA 19103. Mr. Klemm would like to thank Bryan Bolton (head litigation partner) and Daryn Rush (head reinsurance partner) for their significant contributions regarding this article.

- 2 As with so many other aspects of reinsurance law, the DJ issue did not become a volatile one until the asbestos/toxic tort claims of the 1980's. See *Modern Reinsurance Law and Practice* (2nd ed.), Barry Ostrager & Mary Kay Vyskocil (2000) § 7.03. See also *Fireman's Fund Ins. Co. v. General Reinsurance Corp.*, No. C-03-04406 JCS (N.D. Cal. Aug. 5, 2005) at \*12 (“[H]ighly credible” witness notes that the question of DJ expenses was “first raised by reinsurers in the early 1980s . . . in response to rising costs associated with asbestos and pollution claims.”).
- 3 A ceding company can choose when and where to raise its declaratory judgment including whether to file in state or federal court. Given that state laws differ widely on insurance law principles, forum selection should not be undervalued.
- 4 See Eugene Wollan, *Handbook of Reinsurance Law*, (2003) § 2.05[C] (“[O]pinions [regarding DJ expenses] throughout the industry, including those of members of reinsurance arbitration panels, vary widely.”).
- 5 *Affiliated FM Ins. Co. v. Constitution Reins. Corp.*, 416 Mass. 839 (1994).
- 6 *Id.* at 842.
- 7 *Id.* at 842-43.
- 8 *Id.* at 841 n.4.
- 9 *Id.* at 845-46 (“Where, as here, the contract language is ambiguous, evidence of trade usage is admissible to determine the meaning of the agreement.”); (“Where, as here, the contract language is ambiguous, evidence of custom and trade practice may be admitted to arrive at an interpretation . . .”).
- 10 *Id.* at 846.
- 11 *Id.* at 845.
- 12 *Id.* at 846.
- 13 *Id.* at n.9.
- 14 E. Allan Farnsworth, *Farnsworth on Contracts* § 7.12a (1990) at 279-80; see also *Western States Constr. Co. v. United States*, 26 Cl. Ct. 818 (Cl. Ct. 1992) (collecting sources).
- 15 *British Int'l Ins. Co. Ltd. v. Seguros Republica, SA*, 342 F.3d 78 (2d Cir. 2003).
- 16 *Id.* at 80.
- 17 *Id.* at 82.
- 18 *Id.* (internal citations omitted).
- 19 *Id.*
- 20 *Id.* at 83.
- 21 *Id.*
- 22 *Id.*
- 23 *Id.* at 84 (internal citations omitted).
- 24 *Id.* at 85.
- 25 202 F. Supp. 2d 1221, 1235 (D. Kan. 2002) *affirmed in part* 358 F.3d 757, 768 (10th Cir. 2004).
- 26 *Id.* at 1236.
- 27 *Id.*
- 28 256 F. Supp. 2d 923 (W.D. Wisc. 2003).
- 29 *Id.* at 924.
- 30 *Id.*
- 31 *Id.* at 925.
- 32 *Id.*
- 33 *Fireman's Fund Ins. Co. v. General Reinsurance Corp.*, No. C-03-04406 JCS (N.D. Cal. Aug. 5, 2005).
- 34 *Id.* at 2-8. Five reinsurance certificates were involved, but this common language can be found in all of them.
- 35 *Id.* at 11.
- 36 *Id.*
- 37 *Id.*
- 38 *Id.* at 16 citing *Affiliated FM Ins. Co. v. Constitution Reins. Corp.*, 416 Mass. 839, 841 n.4 (1994).
- 39 *Fireman's Fund Ins. Co. v. General Reinsurance Corp.*, No. C-03-04406 JCS (N.D. Cal. Aug. 5, 2005) at 12.

- 40 *Id.* at 13. While Gen Re presented contrary testimony, the court was not impressed. For example, one of Gen Re's witnesses could only testify that “in the twenty-four years he has been employed at Gen Re, it has been Gen Re's position that DJ expenses are not covered under its facultative reinsurance certificates . . .” *Id.* However, as the court pointed out, his career did not begin until 1981, the time when the DJ issue was starting to explode. Another witness testified that “it was the intention of involved underwriters that the coverage afforded under the certificates was limited to the risk assumed by the cedent under policies issued to insureds.” *Id.* at 13-14. The court found this testimony “unconvincing” because the witness had failed to lay the “factual foundation in support of his statement purporting to describe” the underwriters intentions. *Id.* at 14.
- 41 Gilmartin also provided testimony in *Affiliated FM* after the Massachusetts Supreme court overruled the summary judgment motion for the reinsurer. (Declaration of William J. Gilmartin ¶8, May 31, 2005).
- 42 *Fireman's Fund Ins. Co. v. General Reinsurance Corp.*, No. C-03-04406 JCS (N.D. Cal. Aug. 5, 2005) at 18.
- 43 *Id.*
- 44 *Id.* at 18-19.
- 45 *Id.* at 19.
- 46 *Id.*
- 47 *Id.*
- 48 *Id.* at 12-13.
- 49 *Id.* at 19.
- 50 *Id.*
- 51 *Id.* at 18.
- 52 *Id.* citing *British Int'l Ins. Co. Ltd. v. Seguros Republica, SA*, 342 F.3d at 80, 83.
- 53 *Fireman's Fund Ins. Co. v. General Reinsurance Corp.*, No. C-03-04406 JCS (N.D. Cal. Aug. 5, 2005) at 18.
- 54 *Id.* at 17.
- 55 *Id.*
- 56 *Id.* at n.3.