How Preserving Reinsurance Can Shape Coverage Counsel's Resolution of High-Exposure Claims

July 10, 2026

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Reinsurance agreements, particularly those with "follow the settlements" and "follow the fortunes" clauses, can significantly impact settlement strategies and insurance coverage decisions by insurance carriers and their coverage counsel. As will be discussed more below, these clauses typically obligate the reinsurer to honor settlements made by the ceding primary insurer, provided the settlement was reasonable, not fraudulent and made in good faith. This obligation has historically helped to avoid disputes between a ceding insurer and the reinsurer. But as society as a whole has become more litigious, so too has the relationship between insurers and reinsurers. However, it also means that the ceding insurer – and their counsel - must carefully consider the impact of their settlement decisions on the reinsurer and ensure that their settlement is defensible under the reinsurance contract so as to be ultimately collectible by the ceding insurer.

While reinsurance can provide protection for the insurer from large insured risks, it also means that the reinsurer can potentially hold the insurer accountable for allegedly bad faith claims if the settlement was not reached "in good faith" or if the insurer failed to follow the terms of the reinsurance agreement. This potential adverse situation requires a ceding carrier's counsel to carefully weigh the risks and benefits of different settlement options – and even whether to settle at all. For if it is possible that the reinsurer might reject the settlement determination of the primary carrier, then the insurer's counsel might instead let the case go to judgment.

In addition, there are provisions commonly found within reinsurance contracts that will have an effect on the way insurer's coverage counsel should handle coverage disputes where reinsurance coverage is ultimately likely to be triggered. For example, "follow the settlements" clauses are typically found in reinsurance agreements and mean that the reinsurer will reimburse the cedent the amount of the settlement if it was reached in "good faith" and if the settlement was within the terms of the reinsurance contract. This can provide the ceding insurer's counsel with more certainty and less risk in settling claims because they know the reinsurer will cover the costs if they make a reasonable settlement.

"Follow the fortunes" provisions typically mean that a reinsurer will accept an insurer's good faith coverage decisions where a judgment has been entered against the cedent's insured. Again, as long as the decision to provide coverage for the rendered judgment was made in good faith, the ceding insurer's counsel should be more confident that the coverage decision will be followed by the reinsurer.

"Claim control" and "right to associate" provisions within some reinsurance agreements give the reinsurer the right to influence or even control how the ceding insurer handles claims, including settlement decisions. This can give the reinsurer potentially more input into the settlement process and can be helpful to insurers because the reinsurer's involvement makes it more difficult for the reinsurer to later challenge the settlement obtained by the cedent insurer.

Of course, the more control over an underlying claim that the reinsurance agreement grants to the reinsurer, the more likely it is that a court will find that any efforts made by the ceding carrier to interfere with the reinsurer's contractual rights might result in the loss of the reinsurance coverage. On the other hand, the more control that the reinsurer exercises over the claims-handling process, the greater the risk that the reinsurer will face exposure to bad-faith and third-party claims from which it is ordinarily insulated.

THE BASICS OF THE REINSURANCE RELATIONSHIP

Reinsurance is simply insurance obtained by insurers to cover their potential risk from the insurance that they provide to policyholders. The insurance company that buys reinsurance—the ceding carrier—is called the "cedent." The insurance company that sells reinsurance coverage is called the "reinsurer." The agreements between a cedent and its reinsurer typically fall into two basic categories. A "facultative" reinsurance agreement - often referred to as a facultative certificate – reinsures a specific insurance policy for a specific term. A "treaty" reinsurance agreement is quite different, in that it might reinsure multiple policies, and can encompass several policy periods.

If a ceding insurer is seeking payment under a reinsurance agreement for payment made under an insurance policy for a settlement or judgment, the ceding insurer has to demonstrate that it paid an underlying claim that comes within both the underlying insurance contract and the reinsurance agreement. Again, in the first instance, the ceding insurer has the burden to show that the payment was made under a policy that is reinsured by the reinsurance agreement and that the payment was proper within the terms and provisions under both contracts.

The burden then shifts to the reinsurer to prove that payment was improper or that there is some other basis to refuse payment under the contracts. For example, within direct insurance disputes, it is well known that the insurance company seeking to avoid a claim payment has the burden to prove that an exclusion to coverage applies. The policyholder need only prove is that there is an insurance policy and there is a claim that falls within the coverage grant. It is the insurance company's burden to prove that an exclusion precludes coverage. Similarly, in a reinsurance dispute, where the reinsurer, for example, claims that an exclusion under the reinsurance agreement applies, the reinsurer has the burden of showing that the reinsurance agreement does not cover the reinsured risk. The trigger for payment by a reinsurer is often actual payment by the cedent of a claim either in settlement or as a judgment. Reinsurance agreements are essentially indemnification agreements, and unless and until the insurer has paid or is required to pay an underlying settlement of judgment, the reinsurer has no obligation to pay the claim.

THE RULES THAT DEFINE THE RELATIONSHIP BETWEEN CEDENTS AND REINSURERS

In almost all cases, in dealing with each other, the cedent and its reinsurer owe one another a duty of "utmost good faith." See, e.g., *Compagnie de Reassurance d'lle de rance v. New England Reinsurance Corp.*, 944 F. Supp. 986, 992-93 (D. Mass. 1996) *Natl. Indemnity Co. v. Global Reins. Corp. of Am.*, 803 F. Supp. 3d 789, 832 (D. Nebraska 2025). Two doctrines, which are separate but related, spring from that duty and are a part of virtually every reinsurance relationship. First, the "follow the fortunes" doctrine requires reinsurers to accept their cedent's good-faith decisions about whether a particular loss is covered by the underlying policy. Second, the "follow the settlements" doctrine requires reinsurers to abide by their cedents' good faith decisions to settle claims under the policies, instead of litigating them. See *Fireman's Fund Ins. Co. v. OneBeacon Ins. Co.*, 49 F. 4th 105, 12 – 113 (2nd Cir. 2022); *Commercial Union Ins. Co. v. Seven Provinces Ins. Co.*, 9 F. Supp. 2d 49, 66 (D. Mass.1998). These traditional obligations are sometimes expressly incorporated into the reinsurance agreement. Sometimes they are not.

The follow the settlements concept provides that the reinsurer is obliged to accept the settlements made by the reinsured. The follow the fortunes concept provides that the reinsurer shall be bound by developments beyond the reinsured's control.

FOLLOW THE SETTLEMENTS

Many reinsurance certificates contain follow the settlement provisions, which can vary in breadth and detail. One example of such a provision is as follows:

"All good faith settlements, compromises and adjustments of claims under the Policy Reinsured made by [cedent] including those involving coverage issues and/or the resolution of whether such claims are required by law, regulation, or regulatory authority to be covered (or not to be excluded) thereunder, shall be binding on [reinsurer]."

The reinsurer's duty to follow the reinsured's settlements is subject to two requirements: first, the claim as settled by the reinsured is "arguably covered" by the underlying contract; and second, the claim as recognized is within the coverage of the contract of reinsurance as a matter of law.

"Arguably covered" requires that the settlement of claims made by the reinsured is not collusive, fraudulent, deceptive, grossly negligent or reckless, clearly outside of coverage, or beyond the amount of limits set forth in the policy. In determining what constitutes an unreasonable settlement, the reinsurer should take into account the risks that the insurer had if it had not settled, including potential bad faith claims filed by its policyholders and possible significantly greater damages at trial.

If it cannot be said after considering these issues that no "reasonable person" would support the settlement, the settlement should generally be considered sufficiently reasonable to support the cession. Therefore, the settlement will likely be found reasonable if the insurer acted in good faith and took all appropriate and reasonable steps in determining coverage and deciding to settle the claim.

Courts have held that, in connection with follow the settlements provisions, "the proper minimum standard for bad faith should be deliberate deception, gross negligence or recklessness." *Am. Bankers Ins. Co. of Fla. v. Northwestern Nat. Ins. Co.*, 198 F.3d 1332, 1336 (11th Cir. 1999); *ReliaStar Life Ins. Co. v. IOA Re, Inc.*, 303 F.3d 874, 881-82 (8th Cir. 2002) (following American Bankers). But see *Public Risk Mgmt. v. Munich Reinsurance America*, 38 F. 4th 1298, 1310 (11th Cir. 2022)(Court noted that it would not infer a follow-the-fortunes provision where "the plain, unambiguous language of the relevant insurance provisions are inconsistent with the follow-the-fortunes doctrine."

The standard derives from the Second Circuit's decision in *Unigard Sec. Ins. Co. v. N. River Ins. Co.*, 4 F.3d 1049 (2d Cir. 1993). There, in determining the standard for bad faith that would allow a reinsurer to assert a late notice defense without proving prejudice, the court held that the "proper minimum standard for bad faith should be gross negligence or recklessness." Id. at 1069. The court explained that:

. . . if a ceding insurer has implemented routine practices and controls to ensure notification to reinsurers but inadvertence causes a lapse, the insurer has not acted in bad faith. But if a ceding insurer does not implement such practices and controls, then it has willfully disregarded the risk to reinsurers and is guilty of gross negligence. Id.

A duty to follow the settlement can only arise where the claim is covered by the contract of reinsurance. A duty to follow the reinsured's settlements is, thus, limited to the scope of cover of the contract of reinsurance and does not expand this scope. See *Fireman's Fund Ins. Co. v. OneBeacon Ins. Co.*, 49 F. 4th 105, 113 (2nd Cir. 2022). The relevant claim is the one as recognized in the settlement and the reinsured does not have to rove that the original claim falls within the risks covered by the contract of reinsurance.

FOLLOW THE FORTUNES

The follow the fortunes principle covers developments beyond the reinsured's control and this includes coverage of judgments against the reinsured. Even though the reinsured may have some influence on the judgment by exercising its rights as a party to the proceedings, ultimately the decision by the court is outside of its control. This will apply irrespective of whether the reinsurer approves the cedent's defense strategy or not. One example of a follow the fortunes clause is as follows:

"The liability of the Reinsurers shall attach simultaneously with that of the Reinsured, and shall be subject in all respects to the same risks, terms, conditions, waivers, and to the same modifications, alterations and cancellations as the respective original insurance (or reinsurance) of the Reinsured, the true intent of this Agreement being that the Reinsurer shall, in every case to which this Agreement applies, follow the underwriting fortunes of the Reinsured."

Another, simpler, example of a follow the fortunes provision is as follows:

"All cessions under this Agreement shall be subject to the same terms and conditions as those binding upon the Reinsured under the original acceptances. The Reinsurers shall, subject to the terms and conditions of this Agreement, follow the underwriting fortunes of the Reinsured."

While the follow the fortunes provision in a reinsurance agreement would seemingly require the reinsurer to pay any claim ceded to it by the insurer after a judgment is entered in a coverage dispute against the insurer, this might not be the case where the reinsured purportedly failed to put forward apparent defenses to coverage. Under such circumstances, the reinsurer might argue that the follow the fortunes rule should not be applicable because of the coverage decisions made by the insurer.

In *North River Ins. Co. v. Cigna Reinsurance Co.*, 52 F.3d 1194 (3d Cir. 1995), the Third Circuit noted that to deny reimbursement under the "follow the fortunes" doctrine, it is the reinsurer's "burden to prove" that the applicable law would not support coverage. See id. at 1209- 1210. The burden of proof is on the reinsurer is well-established law, as well. See, e.g., *Travelers Cas. & Surety Co. v. Insurance Co. of North America*, 609 F. 3d 143, 150 (3d Cir. 2010), citing *Mentor Ins. Co. (UK) Ltd. v. Brannkasse*, 996 F.2d 506, 517 (2d Cir. 1993)(Court ruled that it is the reinsurer seeking to avoid payment - not the reinsured - who "must show either that the coverage decisions that led to the reinsurer's liability to the insurer were made in bad faith, or that the coverage provided clearly fell outside the scope of the policies the reinsurer agreed to reinsure," otherwise the reinsurer must simply cover the losses allocated to it.) See also *Fireman's Fund Ins. Co. v. OneBeacon Ins. Co.*, 49 F. 4th 105, 112 - 113 (2nd Cir 2022) (Court noted that "follow-the-settlements principle applies also to a cedent's post-settlement allocation decisions ... as long as the allocation meets the typical follow-the-settlements requirements.") (Internal citation omitted).

A reinsurer must also usually show that the cedent acted in "bad faith" in determining that the underlying claim was covered under the insurance policy at issue. The New York Federal District Court noted that "[a] reinsurer who seeks to avoid application of follow-the-fortunes by claiming bad faith . . . must make an extraordinary showing of a disingenuous or dishonest failure." See *National Union Fire Ins. Co. v. American Re-Insurance Co.*, 441 F.Supp.2d 646, 650 (S.D.N.Y. 2006) (applying New York law). See also *Fireman's Fund Insurance v. OneBeacon Insurance*, 495 F. Supp. 3d 293, 310 – 311 (S.D.N.Y. 2020)(Court stated that where there was no genuine issue of material fact as to whether the settlement is reasonably within the terms of policy at issue, and that reinsurer had not argued that cedent's settlement was otherwise unreasonable or reached in bad faith, the "follow-the-fortunes" doctrine applies.). As such, it is imperative that counsel representing insurers be both cautious and diligent in demonstrating that coverage decisions made in litigating coverage disputes will withstand potential scrutiny later on by a reinsurer reviewing the cession of an adverse judgment against the insurer.

Another example of potential problems facing insurers' counsel with respect to the application of the follow the fortunes rule is where there is a question of coverage for punitive damages under the primary insurance policy. For instance, if the law governing the underlying insurance contract forbids the coverage of punitive damages but lifts such a ban later-on, such change expands the reinsured's cover under the underlying contract. The reinsurer must follow the cedent's fate unless the reinsurance agreement specifically excludes coverage of punitive damages. But if the reinsurance agreement instead "follows form" to the insurance policy, then the question is whether the insurance policy explicitly precludes coverage for punitive damages, or does it specifically cover punitive damages under certain circumstances.

One such provision in an insurance policy covering punitive damages under certain circumstances is as follows:

"Loss does not include . . . Punitive or exemplary damages except to the extent allowed by law in the applicable jurisdiction and incurred in addition to and in connection with an otherwise covered Loss."

One jurisdiction that allows for coverage of punitive damages under certain limited circumstances is Massachusetts. In Massachusetts, insurers are permitted to cover insureds for liability resulting in an award of punitive damages arising from "harm caused by reckless misconduct." See Massachusetts General Laws Chapter 175, § 47, Clause Sixth (b). See also *Williamson-Green v. Interstate Fire & Casualty Co.*, 1684 CV 03141-BLS2 (Mass. Super. May. 26, 2017), citing *Sheehan v. Goriansky*, 321 Mass. 200, 204 (1947), quoting Restatement of Torts § 500 comment f (1934); *Andover Newton Theological Sch., Inc. v. Continental Casualty Co.*, 409 Mass. 350, 352 (1991) ("Indifferent or reckless wrongdoing is not deliberate or intentional wrongdoing.")

A dispute between a cedent and a reinsurer might arise where a punitive damages verdict was entered by a jury against a policyholder after a judge's instruction as to "willful, wanton, or reckless" conduct. While an insurer might find that this award of punitive damages was insurable because the jury could have reached its decision on account of the insured's "recklessness," the reinsurer might challenge the cession of the punitive damages award, arguing that it was not clear that the jury based its punitive damages award on the insured's reckless behavior instead of the insured's "willful" intentional behavior. Under such circumstances, it would behoove coverage counsel for the insurer to make sure that the jury instructions – and any jury questions to be answered – make clear that the jury is ruling only on the insured's alleged "reckless" behavior, and not intentional or willful conduct.

RIGHT TO ASSOCIATE CLAUSES

The "follow the settlements" doctrine requires the reinsurer to cover settlements made by the cedent, so long as those settlements are not fraudulent, collusive, or made in bad faith. As a result, reinsurance contracts may contain language that grants the reinsurer rights about the handling of the underlying claim. These clauses are more likely to appear in facultative contracts than in treaty programs. In sum and substance, the "right to associate" is the right of a reinsurer to "consult with and advise the reinsured in its handling of a claim." See *Unigard Sec. Ins. Co. v. N. River Ins. Co., Inc.*, 594 N.E.2d 571, 575 (N.Y. 1992).

One example of a notice requirement that affects a reinsurer's right to associate under a reinsurance agreement is as follows:

"Prompt notice shall be given by the reinsured to the reinsurer of any occurrence which appears likely to involve this reinsurance, and while the reinsurer does not undertake to investigate or defend claims or suits, it shall nevertheless have the right and be given the opportunity to associate with the reinsured at the reinsurer's expense in the defense and control of any claim, suit, or proceeding which may involve this reinsurance, with the full cooperation of the reinsured."

A "right to associate" is not the right to control the investigation or defense of a claim, and it does not necessarily give the reinsurer the right to control settlement. See *Unigard*, 594 N.E.2d at 574; *British Ins. Co. of Cayman v. Safety Nat'l Cas.*, 335 F.3d 205, 214 (3d Cir. 2003). Indeed, the purpose of most "association" clauses is to give the reinsurer information about the underlying claim, not to compel the reinsurer to undertake to investigate or defend claims or suits. he cases involving the right to associate tend to focus on two elements of the right to associate clause. The first element is whether late notice by the cedent impairs the reinsurers' contractual rights, such that performance under the reinsurance contract is excused. The modern trend has been to require the reinsurer to demonstrate prejudice caused by its inability to exercise its right to associate.

New York's courts, for example, adopted a "notice-prejudice rule" in the reinsurance context long before the notice-prejudice rule was applied to direct insurance policies by statute. See *Unigard*, 594 N.E.2d at 574-75; *Utica Mut. Ins. Co. v. Fireman's Fund* Ins. Co., 287 F. Supp. 3d 163 172 (N.D.N.Y 2018). In *British Intl Ins. Co. of Cayman*, 335 F.3d 205 (3rd Cir. 2003), the Third Circuit stated that it believed that the Supreme Court of New Jersey would follow the rule set forth in Unigard and would rule that, under New Jersey law, a reinsurer must show the likelihood of appreciable prejudice in order to prevail on a late notice defense asserted against the cedent. Id. at 214.

The Third Circuit noted that since a reinsurer is not obligated to investigate, litigate, settle or defend claims, the "failure to give the required prompt notice is of substantially less significance for a reinsurer than for a primary insurer." Id. quoting Unigard, 594 N.E.2d at 574. The Third Circuit stated that "[c]onsequently, prompt notice is not as critical to a reinsurer as it is to a primary insurer, and ritualistic adherence to prompt notice clauses in reinsurance contracts in the absence of prejudice to the reinsurer does little more than provide the reinsurer with a convenient and inequitable avenue to escape from its obligations under its policy with its reinsured." See *British Intl Ins. Co.*, 335 F. 3d at 214, quoting Unigard, 594 N.E.2d at 574. See also *Key Star Partners, LLC v. Insignia Disposal Services, LLC*, C.A. No. 22-2338 (E.D. Penn. April 12, 2023) (internal citation omitted)(Court stated that "Pennsylvania Courts would apply a must-show-prejudice rule to reinsurance contracts, even when a contract makes the notice provision an express condition precedent to coverage.") There is a minority view, however, mainly in older decisions, holding that a cedent's failure to abide strictly by a provision that expressly made timely notice a condition precedent to liability precluded coverage under the reinsurance agreement. See, e.g., *Liberty Mut. Ins. Co. v. Gibbs*, 773 F.2d 15 (1st Cir.1985).

The second element is whether the reinsurer's exercise of its association rights exposes the reinsurer to bad-faith and other direct claims. Courts in New York and Pennsylvania have articulated a rule that reinsurers cannot be subject to bad-faith claims, because the reinsurer is not responsible for providing a defense to the cedent's policyholder and therefore has no ability to control settlements. See, e.g., *Unigard*, 594 N.E.2d at 574; *Reid v. Ruffin*, 469 A.2d 1030, 503 Pa. 458, 463 - 464 (Pa. 1983); *The Hartford Steam Boiler Inspection and Insurance Company v. International Glass Products*, LLC, No. 2:08cv1564 (U.S.D.C., W.D. Penn., Sept. 29, 2016)(citing Reid).

An older case from the Fourth Circuit, however, held that the cedent and the reinsurer were "unquestionably" engaged in a joint enterprise when the reinsurer had full knowledge of settlement negotiations with the underlying claimant, even though the reinsurer had never formally exercised its right of association, such that the reinsurer was liable for its proportionate share of an excess verdict. See *Peerless Ins. Co. v. Inland Mut. Ins. Co.*, 251 F.2d 696 (4th Cir. 1958). But see *U.S. Fid. & Guaranty Co. v. American Re-Ins. Co.*, 93 AD 3d 14, 28 (N.Y. App. Div., 1st Dept. 2012)(where the New York Appellate Division declined to follow Peerless.)

Coverage counsel should be aware of any right to associate with their insurer client that the reinsurer might possess in the reinsurance agreement. Counsel representing insurers should counsel their clients to strictly adhere to the notice requirements set forth in reinsurance agreements. Even though in most cases, the reinsurer will be required to demonstrate prejudice, nevertheless, it will be helpful if insurers promptly provide notice of claims that will likely be ceded, because the reinsurer's involvement makes it more difficult for the reinsurer to later challenge the settlement obtained by the cedent insurer.

CLAIM CONTROL CLAUSES

A "claim control" clause, sometimes called a "claim cooperation" clause, gives the reinsurer either the option, or the obligation, to exercise actual control over all or a portion of the claim handling process. The clause may, depending on how it is written, give the reinsurer the right to consent to settlement, or the right or obligation to investigate, adjust, or resolve claims. Because the clause gives the reinsurer the right to exercise actual control over the claim, the related notice provisions may specify a fairly short timeframe and a particular form of notice. The clauses tend to appear more frequently in reinsurance agreements where the cedent has retained little or no risk.

For "claim control" clauses, as distinguished from "right to associate" clauses, timely notice of the claim can be critical. The issue has received mixed treatment in the United Kingdom. What case law exists in the United States has tended to apply the notice clauses strictly. In *La Reunion Francaise v. Martin*, 101 F.3d 682 (2d Cir. 1996) (unpublished), for example, the Second Circuit affirmed an arbitration award ruling that a claims-control clause required only that the reinsurer indemnify its cedent for expenses incurred after the date on which the reinsurer instructed the cedent on how to handle the claim. As such, counsel representing insurers should make sure that their clients strictly adhere to the notice requirements set forth in reinsurance agreements that contain "claim control" language. Otherwise, the failure to provide notice during the claim handling of the coverage dispute might doom the insurer's ultimate cession of the matter to its reinsurer.

Of course, a reinsurer should also carefully consider how and whether to exercise any right to control the underlying claim. If it does, depending on the language in the reinsurance agreement, the reinsurer can expose itself to direct claims by the insured or by the underlying claimant—or even by third parties that ordinarily would not be in privity with the reinsurer. One example of such exposure was provided in the case of Law Offices of David J. Stern, *P.A. v. SCOR Reinsurance Corp.*, 354 F. Supp. 2d 1338 (S.D. Fla. 2005), in which a law firm had purchased a lawyers' professional liability insurance policy from Legion Insurance Company.

In this case, when the law firm sued for alleged breach of the policy, the Florida federal district court declined to dismiss the claim against the reinsurer. The District Court stated that the reinsurer had the right to control the handling and resolution of claims under the Legion policy, and the court held that that fact was sufficient to state a claim either that the reinsurer had breached the liability policy because it had induced Legion to refuse to indemnify the attorney, or that it had tortuously interfered with the insurer's contractual obligations to the attorney. Id. at 1342 – 1343. See also *Casa Besilu LLC v. Federal Insurance Company*, C.A. No. 20-24766-Civ-Scola (U.S.D.C., S.D. Florida, April 23, 2021)(citing SCOR).

CONCLUSION

As noted above, the existence of reinsurance can affect settlement strategies and insurance coverage decisions by insurance carriers and their coverage counsel. While most reinsurance agreements require reinsurers to honor settlements made by the ceding primary insurer, reinsurers can balk at covering such settlements where they claim that the settlement was not reasonable, fraudulent and not made in good faith. Therefore, the ceding insurer – and their counsel - must carefully consider the impact of their settlement decisions – and how they reach them - on the reinsurer and make sure that all settlement decisions can be shown to have been made in good faith and are covered in compliance with the reinsurance contract.

The insurer must also make sure to avoid inadvertently interfering with the reinsurer's right to control the underlying claim and the reinsurer's right to associate in the handling of the underlying claim as set forth in some reinsurance agreements, including settlement decisions. Hindering the reinsurer's claim control and association rights, particularly through a failure to timely notify the reinsurer, can needlessly endanger the insurer's cession of an underlying judgement or settlement. Moreover, if claims counsel advises their insurer clients to give the reinsurer potentially more input into the settlement process, this can only help the insurers ultimate cession because the reinsurer's involvement makes it more difficult for the reinsurer to later refuse to cover the cession.

Originally published in DRI For the Defense.