

ALLOCATION TO REINSURERS

AND

FOLLOW THE SETTLEMENTS

By

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I. Introduction

Follow the settlements (sometimes used interchangeably with "follow the fortunes")^[1] is a powerful concept in the resolution of disputes between cedents and reinsurers. There are myriad cases holding that a reinsurer may not second guess the settlement decisions of a cedent. However, a different issue is presented when the reinsurer accepts the reasonableness of the settlement but not the cedent's proposed allocation thereof between itself and its reinsurer. It would be naive to suggest that the financial interests of each party to the reinsurance transaction are not a motivating force in the positions they take.^[2] The purpose of this article is to explore existing case law and policy arguments in an effort to determine whether follow the settlements is an appropriate tool to be applied to allocation decisions.

II. Traditional Follow the Settlements Case Law

Traditional follow the settlements case law has developed into legal sound bites. "Follow the fortunes clauses prevent reinsurers from second guessing good-faith settlements and obtaining de novo review of judgments of the reinsured's liability to its insured." North River Ins. Co. v. CIGNA Reins. Co., 52 F.3d 1194 at 1199 (3rd Cir.1995). The interests of cedents and reinsurers are aligned on claims and the interests of both parties are furthered by allowing the cedent to settle the dispute on the best terms possible. Unigard Sec. Ins. Co. v. North River Ins. Co., 594 N.E.2d 571, 574 (N.Y.1992). The court observed in International Surplus Lines Ins. Co. v. Certain Underwriters & Underwriting Syndicates at Lloyd's of London, 868 F.Supp. 917, 921 (S.D.Ohio 1994):

Were the Court to conduct a de novo review of [the insurer'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.

Nonetheless, the follow the settlements concept has certain boundaries. It does not apply to settlements obtained by fraud or collusion or losses outside the boundaries of the underlying policy. North River Ins. Co., 52 F.3d at 1207. In addition, the loss must be one that is covered under the reinsurance contract. *Id.* at 1206. With respect to this last point, it is significant for the analysis below that the follow the settlements doctrine, in its traditional context, does not supercede the reinsurance contract.

III. Court Application of Follow the Settlements Doctrine to Reinsurance Allocation

A. Cases Declining to Require the Reinsurer to Follow the Cedent's Allocation

Travelers Cas. and Surety Co. v. Certain Underwriters at Lloyd's of London, 760 N.E.2d 319 (N.Y.2001) involved a \$140 million settlement of environmental claims in which Travelers treated each site as a separate occurrence.^[3] Travelers attempted to cede the claim to its reinsurers as one disaster or casualty which was defined as "all loss resulting from a series of accidents, occurrences and/or causative incidents having a common origin . . ." *Id.* at 323. The court held that the settlement of many claims at multiple sites over many years was not one "disaster or casualty" and found follow the settlements case law irrelevant to the allocation issue:

The courts held that the reinsurers were bound by "follow the fortunes" clauses in their reinsurance agreements and, as a result, the reinsurers had to indemnify their reinsureds as long as the payments were made reasonably and in good faith. Here, by contrast, the Reinsurers are not contesting Travelers' settlement decisions based on the underlying policies; rather, the challenge is to Travelers' allocation of those settlements based on the contractual language in the reinsurance treaties.^[4]

Tardy response to a sick individual in a hospital parking lot provided the factual context to the recent case of Employers Reinsurance Corp. v. Newcap Ins. Co. Ltd., 209 F.Supp. 1184 (D.Kan.2002). Employers Re reinsured the cedent, Newcap, under both its hospital liability policy, subject to a \$10 million retention, and the commercial general liability policy, subject to a \$ 1 million retention. Employers Re and Newcap disagreed as to whether the claim fell under the hospital liability or the commercial general liability form but Employers Re paid \$ 6.6 million of the \$ 7.6 million settlement and reserved its rights on point. Newcap argued that Employers Re was obligated to accept its interpretation of which policy was at risk under the follow the settlements doctrine. The court declined to grant summary judgement for Newcap noting that Employers Re had funded the settlement but had reserved its rights on which policy was at risk. Thus there was no agreement on point. The court also commented that this case was distinguished from other follow the settlements cases in that the interests of the cedent and reinsurer were opposed.

Hartford Accident & Indem. Co. v. Columbia Casualty Co., 98 F.Supp.2d 251 (D.Conn.2000) was a summary judgement proceeding by which the cedent attempted to apply the follow the settlements doctrine to its allocation of a settlement. The cedent, Hartford, argued that a settlement of multiple claims at 50 sites plus punitive damages claims and 31 policy buyouts should be treated as one occurrence. This had the effect of maximizing Hartford's reinsurance recoveries and minimizing its retentions. The court noted follow the settlements case law held that a cedent's settlement decision would be binding on the reinsurer unless is was grossly negligent, reckless, in bad faith or not within the reinsurance coverage. The court found that there was sufficient evidence that Hartford's allocation was grossly negligent or reckless and should go a trier of fact:

While Hartford contends that its allocation of the entire settlement to the Newsom Site was completely reasonable, the above facts could support inferences from which a factfinder could conclude that Hartford's conduct manifested gross negligence or recklessness. Such disputes as to the proper inferences to be drawn from these facts and circumstances requires determination by a jury.^[5]

B. Cases Which Require the Reinsurer to Follow the Cedent's Allocation

The seminal case applying the follow the settlements doctrine to allocation is Commercial Union Ins. Co. v. Seven Provinces Ins. Co., 9 F.Supp.2d 49 (D.Mass.1998) *aff'd on other grounds* 217 F.3d 33 (1stCir.2000) *cert. denied* 531 U.S. 1146 (2001). The ceding company, Commercial Union, brought suit for reinsurance recoverables and under a Massachusetts statute for unfair practices in stonewalling the reinsurance claim. The judge's finding in favor of the cedent on the latter point set the tone for the decision.^[6] The fact situation was a \$ 2.2 million settlement of 22 sites and a general release with \$843,000 of this sum allocated to one site. Seven Provinces argued for a different allocation which would have reduced the allocation to this site and required the application of additional ceding company retentions.

In making a factual decision on the reasonableness of the allocation, the Seven Provinces court cited evidence that the allocation to reinsurers followed the settlement negotiations with the insured and that the percentage of allocation was divided between the seven key sites in accordance with the projected cost of clean-up. The court

found that the allocation was reasonable, not in bad faith and did not exhibit an effort to maximize the cedent's reinsurance recoverables.^[7]

The court then turned to the application of the follow the settlements argument as a matter of law. Noting the many possible ways in which claims may be allocated, and without citing any supporting case law, the court ruled:

I therefore conclude that the doctrine of "follow the settlements" requires the reinsurer to follow the reinsured's good faith and reasonable allocation of settlement dollars between different policies and sites. Therefore, my conclusion as to the reasonableness and good faith of CU's allocation of the Teledyne settlement dispenses with Seven Provinces' challenges to payment on this front.^[8]

The Seven Provinces decision was followed in North River Ins. Co. v. ACE American Reinsurance Co., 2002 WL 506682 (S.D.N.Y.) which was a summary judgement decision in favor of the cedent on allocation.

C. Comments on Case Law

Existing case law is hardly a model of clarity for practitioners. The New York Court of Appeals asserted a bright line rule that the follow the settlements doctrine does not apply to allocation in Travelers Cas. and Surety Co. v. Certain Underwriters at Lloyd's of London, 760 N.E.2d 319 (N.Y.2001). However, Employers Reinsurance Corp.v. Newcap Ins. Co. Ltd., 209 F.Supp. 1184 (D.Kan.2002) turned on funding by the reinsurer and reservations of rights. Hartford Accident & Indem. Co. v. Columbia Casualty Co., 98 F.Supp.251 (D.Conn.2000) seemed to accept the application of the follow the settlements doctrine but found evidence of gross negligence and self-dealing in the allocation.

More troublesome is the ruling in Commercial Union Ins. Co. v. Seven Provinces Ins.Co., F.Supp. 49 (D.Mass.1998). Having found the allocation to be reasonable as a matter of fact, there was no need for the court to address the application of the follow the settlements doctrine to allocation as a matter of law, thus rendering its ruling on point *dicta*. In addition, the court's ruling on the legal issue, unburdened as it was by supporting case law, may be viewed, merely, as a restatement of its factual findings in a different garb. Finally, the court noted that Seven Provinces's arguments on allocation were thinly veiled attacks on the underlying settlement which is governed by follow the settlements: "In the first place, a number of attacks it launches on CU's allocations are in actuality attacks on the settlement."^[9] This suggests that the case is less about allocation and more about the underlying settlement.

Perhaps better direction can be supplied to the courts through comparing and contrasting the policy issues inherent in these matters.

IV. **Policy Analysis of Follow the Settlement Doctrine and Allocation to Reinsurers**

A. Follow the Settlements

The focus of this doctrine is on the policy between the cedent and the insured *i.e.* a contract to which the reinsurer is not a party. The purpose is to prevent a non-party from driving the interpretation of this contract and, in effect, providing disincentives for a settlement between the parties of what may be a very complex dispute, both legally and factually. In effect, the cedent should not be held hostage to what, if any, coverage interpretation of the policy is held by the non-party reinsurer, so long as the cedent acts reasonably and in good faith.

It is hardly surprising that the courts would seize upon and adopt the follow the settlements doctrine. It promotes settlement and rids the docket of very large and difficult cases involving such matters as pollution and asbestos. Likewise, it squares with notions of "rough justice" when there is no obvious reason why the economic interests of the cedent and reinsurer are not aligned.

However, there are and should be exceptions to the follow the settlements doctrine when interests are not aligned. These exceptions include claims clearly outside the coverage of the policy, fraud, bad faith and recklessness or gross negligence in making the settlement. In such cases, the cedent has forfeited its expectation that the reinsurer should not second guess reasonable settlement decisions.

Perhaps the critical exception (or more accurately parameter to the doctrine) for present purposes is that the follow settlements doctrine does not supercede or create coverage under the reinsurance agreement. The cedent can use the doctrine as a shield to prevent second guessing on policy-related decisions but not as a sword to determine the meaning of the reinsurance contract. Thus, the parameters of the follow the settlements doctrine does not extend to determining the meaning of the reinsurance contract.

B. Allocation to Reinsurers

Allocation relates to whether and in what manner the reinsurance contract covers a claim by a cedent. It is not a judgement on the merits of a settlement under the policy or an attempt to second guess it. The settlement with the policyholder or claimant remains in place regardless of the manner in which reinsurance applies.

Unlike the follow the settlements context, allocation depends on a contract between the cedent and the reinsurer. These contracts are entered into by large, national or international financial institutions with virtually no limitations on how they can structure the transaction and its documentation. There is no obvious reason why the cedent's interpretation of the reinsurance contract should be given preference over the reinsurer's any more than the reinsurer's interpretation of the policy should take preference over that of the cedent.

Allocation is a different issue from follow the settlements and involves a different contract and different parties. The follow the settlements doctrine is misplaced and inappropriate in the reinsurance allocation context.

Allocation is a very difficult issue both for the courts and reinsurance arbitrators who probably hear the majority of such disputes. There are many ways in which claims can be allocated to reinsurers and it is challenging for courts and arbitrators to choose which comport with the reinsurance contract and are most appropriate. However, allocation to reinsurers should be decided on two bases: (1) the terms of the reinsurance contract and the good faith obligations inherent therein and not on a doctrine dealing with a settlement pursuant to the underlying policy; and (2) consistency with the manner of settlement of the underlying loss.^[10]

V. **Conclusion**

The follow the settlements doctrine is a powerful force in resolving disputes concerning the settlement of claims by cedents. With certain exceptions, it prevents reinsurers from second guessing the cedent's decision to settle a claim under a policy. Problems arise, however, concerning the extension of this doctrine to the allocation of losses under a different contract between different parties.

With the possible exception of Travelers Cas. and Surety Co. v. Certain Underwriters at Lloyd's of London, 760 N.E.2d (N.Y.2001), the courts have not analyzed the policy issues inherent in such an extension resulting in a handful of confusing and contradictory decisions. It is submitted that a rigorous analysis of these policy issues indicates that the parameters of the follow the settlements doctrine are limited to the settlement of underlying claims and do not extend to the allocation of such claims under reinsurance contracts.

ENDNOTES

[1]. "Follow the settlements" is often used interchangeably by the courts and others with "follow the fortunes," however, there are significant differences in the implications of the terminology used. One industry scholar has commented:

Recommended follow the fortunes clauses, properly so titled, expound the congruence of coverage in detail and say nothing about settlement obligations, while follow the settlement clauses, in contracts, deal with an obligation of the reinsurer to accept the reinsured's judgments of particular claims.

Graydon S. Staring, "Law of Reinsurance," at 18-3, Clark, Boardman, Callaghan (1993). For both accuracy and consistency, this article will use the term "follow the settlements" unless the language of court rulings requires otherwise.

[2]. Eugene Wollan, "Handbook of Reinsurance Law," at 5-17, Aspen Law & Business (2002).

[3]. It should be noted that the exact basis of settlement is often difficult to discern even when the internal correspondence of the cedent and its counsel is examined. Often, it is necessary to infer the basis from the cedent's calculation of its exposure and the manner in which the settlement negotiations proceeded.

[4]. 760 N.E.2d at 329.

[5]. 98 F.Supp.2d at 259.

[6]. The court stated:

I find that Seven Provinces' numerous and constantly shifting requests for information from CU represented an attempt to evade payment of its reinsurance obligations. Not only does the record of correspondence between the parties reflect that Seven Provinces' objections to payment were frequently changing, but Seven Provinces' behavior at trial continued this pattern.

I find that Seven Provinces' intent in its dealings with CU was to delay and object to payment so that CU would compromise the Teledyne bill and agree to a global commutation of all the business between the parties.

9 F.Supp.2d at 65.

[7]. The court stated:

I find that CU's allocation of settlement dollars to the seven most important sites that drove the settlement was reasonable. I find that it was also reasonable to allocate the settlement total according to the percentage of Teledyne's total clean-up liability that each site represented. I was not persuaded that CU should have allocated settlement dollars to sites that were never even discussed in the settlement.

I find that there was no evidence of bad faith or unreasonableness in CU's allocation of settlement monies between its policies with Teledyne.

I find that there is no evidence that CU allocated the settlement among policies so as to maximize its reinsurance recovery, or that its allocation was in any other way affected by the existence of reinsurance.

9 F.Supp.2d at 60.

[8]. 9 F.Supp. 2d at 68.

[9]. 9 F.Supp. 2d at 67.

[10]. The second point is necessary to prevent the cedent from settling the claim on one basis and then allocating it to reinsurers on an entirely different basis which maximizes reinsurance recoveries. The district court in Seven Provinces cited favorably an allocation to reinsurers in a fashion consistent with the logic of the underlying settlement and not as an effort to maximize reinsurance recoveries in finding the allocation reasonable as matter of fact. 9 F.Supp.2d at 58.