

SHOULD FOLLOW THE FORTUNES / SETTLEMENTS

BE IMPLIED INTO REINSURANCE CONTRACTS

By

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I. Introduction

As one court noted, the purpose of the follow the settlements doctrine:

[I]s to prevent the reinsurer from “second guessing” the settlement decisions of the ceding company. Absent such a rule, an insurance company would be obliged to litigate coverage disputes with its insured before paying any claims, lest it first settle and pay a claim only to risk losing the benefit of reinsurance coverage when the reinsurer raises in court the same policy defenses that the original insurer might have raised against its insured. This doctrine adjusts the incentives present in the reinsurance relationship in order to promote good faith settlements by the ceding company. . . . [T]he follow the settlements doctrine imposes upon the reinsurer a contractual obligation to indemnify the ceding company for payments it makes pursuant to a loss settlement under its own policy provided that such settlement is not fraudulent, collusive or otherwise made in bad faith, provided further that the settlement is not an *ex gratia* payment. . . . Consequently, subject to the requirements of good faith and a reasonable, businesslike investigation, the ceding company may bind the reinsurer to follow its settlements when it concedes that a particular claim falls within the scope of coverage provided by the ceding company’s policy.¹

Follow the fortunes or settlements clauses are common but not universal features of reinsurance treaties. The purpose this article is to explore case law on whether or not such clauses should be implied into reinsurance contracts as a matter of law or custom and practice.

II. Case Law Supporting Implying Follow the Fortunes / Settlements Clauses into Reinsurance Contracts

International Surplus Lines Inc. Co. v. Certain Underwriters, 868 F. Supp. 917 (S.D.Ohio 1994) involved a decision by a primary company to pay all Owens-Corning asbestosis losses on a one occurrence basis. The reinsurance contract did not contain a follow the fortunes / settlements clause. The court rejected the reinsurers' arguments that such a settlement was unreasonable. As to reinsurers' obligation to follow the fortunes of the cedent, the court stated:

It is commonly understood that reinsurers must "follow the fortunes" of their insured. This fact may be formally expressed in an agreement of reinsurance. Even if it is not, the "Follow the Fortunes" doctrine [is] applied to all reinsurance contracts.²

In a very brief statement of support for its position, the court cited Mentor Ins. Co. v. Norges Brannkasse, 996 F.2d 506 (2nd Cir. 1993) *infra*, an article by Henry T. Kramer, former CEO of Swiss Re America, also discussed, *infra*, and a decision of a California federal district court which was later reversed. It is not evident from the opinion that the court heard evidence of custom and practice with regard to follow the fortunes.

In Mentor, the cover note stated that the reinsurance coverage is "subject to all terms, clauses, conditions and settlements as original but only to cover in respect of Total and/or Constructive and/or Arranged and/or Compromised Total Loss of Unit."³ The court characterized this as a follow the fortunes clause and discussed the finding of the master below that inclusion of a follow the fortune clause is custom and practice in reinsurance contracts. However, the court found the reinsurers liable on the cedent's claims based on the follow the fortunes clause in the relevant reinsurance contract.⁴ So the court's discussion of implying it into the contract was *dicta*.

A facultative certificate without a follow the fortunes / settlement clause was involved in Aetna Cas. and Surety Co. v. Home Ins. Co., 882 F. Supp. 1328 (S.D.N.Y. 1995). At issue was whether expenses are included within limits. The court heard expert testimony to the effect that follow the fortunes / settlement is implied into reinsurance contracts but, apparently, no testimony to the contrary.⁵ The court held for the cedent stating: "In view of the evidence, the court finds that it is customary within the reinsurance industry for reinsurers to follow the claim settlement decisions of the ceding company even in the absence of an explicit loss settlements clause."⁶

III. Case Law Rejecting Implied Follow the Fortunes / Settlement Clauses into Reinsurance Contracts

National American Ins. Co. v. Certain Underwriters, 93 F.3d 529 (9th Cir. 1996) involved claims under facultative certificates that did not contain follow the fortunes / settlements clauses. The cedent offered expert testimony that such clauses were implied into reinsurance contracts by custom and practice and the underlying court ruled for the cedent on the basis that such expert testimony was uncontradicted. The appellate court found some contradictory evidence in the record and ordered a trial on the custom and practice issue:

Based on an assertive amicus brief filed by the Reinsurance Association of America after our original opinions in this case, and our own review of the record and cases, we now find a factual question as to whether there existed within the facultative industry prior to the 1970's a custom or usage to "follow the settlements." Accordingly, a trial is necessary on this issue.⁷

Another facultative certificate without a follow the fortunes / settlements clause was at issue in Village of Thompsonville v. Federal Ins. Co., 592 N.W.2d 760 (Ct. App. Mich. 1999). The court declined to follow International Surplus Lines, *supra*, or to follow the *dicta* several cases in which the contract contained follow the fortunes / settlements clauses. The court found no Michigan authority for implying follow the fortunes / settlements into the certificate and ruled accordingly.

The district court for the southern district of Ohio again reviewed this issue in North River Ins. Co. v. Employers Reins. Corp., 197 F. Supp. 972 (S.D. Ohio 2002). The fact situation again involved a facultative certificate that did not contain a follow the fortunes / settlements clause. The court viewed the basis for the International court's ruling and subsequent case law. It found that one case supporting the earlier decision had been overturned, the language in another case was *dicta* and that the Henry Kramer article was equivocal on the specific issue at hand. Unlike Aetna Casualty and Surety, there was expert testimony *contra* to the argument that follow the fortunes / settlements is implied into all reinsurance contracts.⁸ Accordingly, the court ruled for the reinsurer:

Whether the "follow the fortunes" doctrine may be implied in a contract by reason of custom or policy will vary depending on which state's laws apply to the contract dispute. This strongly mitigates against a finding that the practice of implying a "follow the settlements" clause in every reinsurance contract is so widespread and accepted in the industry as to be beyond all factual and legal dispute. The above factors indicate that there is no sound basis for applying the "follow the settlements" doctrine in this case as a matter of law.⁹

Whether or not follow the fortunes / settlements should be read into a facultative certificate as a matter of law was the issue in American Ins. Co. v. American Re-Insurance Co., 2006 U.S. Dist. Lexis 85551. After reviewing the above precedents, the court ruled for the reinsurer:

The Court finds that the majority of the courts addressing this issue, and the better reasoned opinions, have rejected the proposition that the “follow the settlements” or “follow the fortunes” doctrine may be implied into every reinsurance policy as a matter of law. In the absence of any authority from Pennsylvania on this issue, the Court will not impute the minority, less well-reasoned position to a Pennsylvania court. Accordingly, the Court . . . will . . . not read the “follow the settlements” or “follow the fortunes” doctrine into the reinsurance contract as a matter of law.¹⁰

IV. Discussion

The weight of the case law seems to be that follow the fortunes / settlements is not implied into reinsurance contracts absent factual evidence that it is custom and practice in the industry. From the cases above, it is clear that some reinsurers do not include traditional follow the fortunes / settlements into their reinsurance contracts. Some of this may result from imprecise use of the terms:

The term “follow the fortunes” has been used imprecisely to describe the reinsurer’s duty to follow the claims adjustment decisions of the ceding company, thereby giving rise to some ambiguity as to its meaning. “Follow the fortunes” more accurately describes the obligation to follow the reinsured’s underwriting fortunes, whereas “follow the settlements refers to the duty to follow the actions of the cedent in adjusting and settling claims.¹¹

While this distinction between “settlements” (claims adjustment) and “fortunes” (underwriting or coverage) has merit,¹² it leaves the follow the fortunes concept largely undefined. Take, for instance, an excess of loss treaty in which unexpected frequency, but low severity, of losses results in a profit to the reinsurer but a loss to the cedent. Does an obligation to follow the cedent’s underwriting fortunes require the reinsurer to disgorge its profits?

Imprecise use of the terms, and the concepts behind them, have caused some courts to morph the follow the settlements concept to allocation issues. In addition to allowing the cedent to make good faith settlement decisions under its insurance policies, the cedent is allowed to make essentially unilateral decisions on how such losses are allocated under the reinsurance contract.¹³ This may be

why some reinsurers resist putting such clauses in their contracts or craft them to apply specifically to the cedent's claim settlements.

ENDNOTES

¹ Aetna Cas. and Surety Co. v. Home Ins. Co., 882 F. Supp. 1328 at 1346 – 7 (S.D.N.Y. 1995

² 868 F. Supp. 917 at 920.

³ 996 F.2d 506 at 508.

⁴ *Id.* at 516 – 7.

⁵ 882 F.3d at 1348 – 50.

⁶ *Id.* at 1350.

⁷ 93 F.3d at 537.

⁸ 197 F. Supp. at 984 – 6..

⁹ *Id.* at 946.

¹⁰ 2006 U.S. Dist Lexis * 15 – 6.

¹¹ Aetna Cas. and Surety Co. v. Home Ins. Co., 882 F. Supp. 1328 (S.D.N.Y. 1995) at 44 n. 9 citing a law review article by William F. Hoffman.

¹² See R. Hall and M. Wulf, Allocation to Reinsurers and Follow the Fortunes, XIII Mealey's Reins. Rpt. 19 at 26 n. 1 (2003) also available at the author's website: robertmhall.com.

¹³ See generally, *id.*