SHOULD FOLLOW THE SETTLEMENTS BE IMPLIED INTO REINSURANCE CONTRACTS (Updated)?[1]

By

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I. Introduction

A follow the settlements (sometimes called "follow the fortunes") clause is often, but not always, used in reinsurance contracts. For instance, two of the largest domestic reinsurance companies[2] adopted a policy of purposefully omitting such clauses on the basis that they carry too much baggage.[3] The purpose of this article is to examine selected case law on whether the follow the settlements doctrine should be implied into reinsurance contracts when the drafters thereof omitted express language on point.

II. Purpose of the Follow the Settlements Doctrine

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.[4]

III. Case Law Supporting Implying Follow the 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 loses on a one occurrence basis. The reinsurance contract did not contain a follow the 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.[5]

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 settlements.

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."[6] 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.[7] So the court's discussion of implying it into the contract was *dicta*.

Another case which addressed follow the settlements in *dicta* was *American Employers' Ins. Co. v. Swiss Reinsurance Am. Corp.,* 275 F. Supp. 2d 29 (D. Mass. 2003). In fn. 32, the court adopted the position that follow the settlements is implied into reinsurance contracts. However, the court found that the reinsurance certificate in question did not cover the cedent's claim.

A facultative certificate without a follow the 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 settlements is implied into reinsurance contracts but, apparently, no testimony to the contrary.[8] 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."[9]

A retrocessional contract without a follow the settlements clause was at issue in Trenwick America Reinsurance Corp. v. IRC, Inc., 764 F. Supp. 2d 274 (D. Mass. 2011). The court found that such as clause should be implied into the contract since experts for both the cedent and reinsurer agreed that follow the settlements "is a core tenant of the reinsurance business" and that "it obligates a reinsurer to

indemnify the ceding company as long as the underlying insurance payments are made in good faith and within the terms and conditions of the reinsurance agreement."[10]

III. Case Law Rejecting Implying Follow the 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 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.[11]

Another facultative certificate without a follow the 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 settlements clauses. The court found no Michigan authority for implying follow the 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. 2d 972 (S.D. Ohio 2002). The fact situation again involved a facultative certificate that did not contain a follow the 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 cited *supra* was equivocal on the specific issue at hand. Unlike *Aetna Casualty and Surety*, there was expert testimony *contra* to the argument that follow the settlements is implied into all reinsurance contracts.[12] 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.[13]

Whether or not follow the 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 95801 (N.D. Cal). 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.[14]

Employers Reinsurance Corp. v. Laurer Indem. Co., 2007 U.S. Dist. LEXIS 45670 (M.D. FL 2007) was a case in which the court was interpreting a reinsurance contract without a follow the settlements clause under Georgia law. The court found that the contract was not ambiguous and under George law, extrinsic evidence on follow the settlements was not admissible to vary the contract.

More recently, a series of facultative certificates that both parties agreed did not contain follow the settlements clauses were at issue in *Utica Mut Ins. Co. v Munich Reinsurance Am. Inc.,* 2018 U.S. Dist. LEXIS (N.D. N.Y.). The court declined to imply follow settlements into the certificates noting that "courts should be extremely reluctant to interpret an agreement as impliedly stating something which the parties have neglected to specifically include."[15]

IV. Discussion

The weight of the case law seems to be that follow the settlements is not implied into reinsurance contracts absent at least a preponderance of extrinsic 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 settlements into their reinsurance contracts. In some cases, at least, this is purposeful as my experience indicates.

ENDNOTES

1 This is an update of an article originally published in 2007.

2 American Re-Insurance Company (now part of the Munich Re Group) and Employers Reinsurance Company, (now part of the Swiss Re Group). I was Senior Vice President and General Counsel of American Re and the Contract Department reported to me. I acted as an expert witness for Employers Re and learned their policy on point from their fact witnesses.

3 This is the sort of baggage that produced such extreme allocation decisions as those described in § II of *Discovery in Reinsurance Allocation Disputes after USF&F v. American Re,* XXIV Mealey's Reins. Rpt. No. 7 (2013), also available on my website, robertmhalladr.com.

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

5 868 F. Supp. 917 at 920.

6 996 F.2d 506 at 508.

7 *Id.* at 516 – 7.

8 882 F.3d at 1348 – 50.

9 *Id.* at 1350.

10 764 F. Supp. 2d 274 at 297.

[11] 93 F.3d at 537.
[12] 197 F. Supp. at 984 – 6..
[13] *Id.* at 946.
[14] 2006 U.S. Dist. LEXIS * 15 – 6.

[15] 2018 U.S. Dist. LEXIS 107997 *70.