The Role of Follow the Form Clauses in Excess Policies and Facultative Certificates

By

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I. Introduction

Commercial insurance is often characterized by towers of insurance and reinsurance consisting of a primary policy, an excess policy and a facultative certificate reinsuring the excess policy. The reasonable expectation of the insured and the primary insurer is that coverage will be concurrent throughout the tower except where explicitly stated otherwise.

A "follow the form" clause is the uniquely simple and efficient means of achieving this concurrency. Such a clause typically states that the liability of the excess insurer or reinsurer shall follow that of the underlying and be subject to all the underlying's term and conditions except as otherwise stated in the excess policy or reinsurance certificate.

In a recent case on the impact on a follow the form clause on a facultative certificate, the court described the testimony of the cedent's experts on the operation of a follow the form clause:

> The Century Experts explained that the Following Form Clause efficiently adopts for the reinsurance the terms and conditions of the insurance without having to draft additional language, which could cause errors or inconsistencies in coverage. They explained that the Following Form Clause includes broad language – namely "in all respects to all the terms and conditions of the Company's policy" – to ensure that all of the insurance policy's terms and conditions apply to the reinsurance. And they explained that the Following Form Clause states that the insurance policy's terms and conditions apply "except when otherwise specifically provided herein or designated as non-concurrent reinsurance in the Declarations" because the presumption is that all of the insurance policy's terms and conditions apply to the reinsurance.[1]

The purpose of this article is to examine selected caselaw applying follow the form clauses.

II. Need for Concurrency

A number of courts have recognized the role of the follow the form clause in supporting concurrency of coverage among policies and reinsurance certificates. In *Global Reinsurance Corp. of America v. Century Indemnity,* 442 F. Supp. 576, 590 (S.D.N.Y. 2020), the court recognized the custom and practice of concurrency and that non-concurrency had to be explicitly stated. The court found that:

> [N]o insurer or broker would accept reinsurance that offered non-concurrent coverage as to expenses because the non-concurrent reinsurer would bear less risk and provide less coverage for the same premium. . . .[I]n a competitive reinsurance market, where the objective is to protect against catastrophic losses, it made no sense for an insurer to accept non-concurrent coverage as to expenses.[2]

Similarly, another court stated:

> Where a following form clause is found in the reinsurance contract, concurrency between the policy of reinsurance and the reinsured policy is presumed, such that a policy of reinsurance will be construed as offering the same terms, conditions and scope of coverage as exist in the reinsured policy, i.e., in the absence of explicit language in the policy of reinsurance to the contrary. Thus, the reinsurance policy indemnifies the reinsured policy for all payments pursuant to its terms unless the exclusion is spelled out in the policy of reinsurance. . . [C]oncurrency between the insurance and reinsurance policies is what makes reinsurance work; . . . [3]

In *Commercial Union Ins. Co. v. Swiss Reinsurance America Corp.*, 413 F. 3d 121, 128 (1st Cir. 2005), the court observed that "concurrence advances one of the basis purposes of reinsurance, which is 'spreading' risk to prevent "a catastrophic loss from falling upon one insurer.'"[4]

See also, American Employers' Insurance Co. v. Swiss Reinsurance America Corp., 413 F.3d 129, 132 (1st Cir. 2005); *Associated International Ins. Co. v. Blythe*, 286 F.3d 789, 782 (5th Cir, 2002). *Travelers Casualty & Surety Co. v. Ace American Reinsurance Co.*, 201 Fed. Appx. 40 (2nd Cir. 2006); *Aetna Casualty & Surety Co. v. Home Insurance Co.,* 882 F. Supp. 1328, 1345 (S.D. N.Y. 1995).

III. Use of Follow the Form Clauses to Resolve Aggregate Issues on Multi-Year Policies

American Employers' Insurance Co. v. Swiss Reinsurance American Corp., 413 F. 3d 129 (1st Cir. 2005) involved a dispute between an excess insurer and its reinsurer over aggregates in a three-year excess policy and facultative certificate. The policy and certificate did not address the issue of whether aggregate limits applied per year (what the court termed annualized) or per three-year term. The cedent settled an underlying claim in a manner consistent with an annualized basis for aggregate limits. The appellate court overturned and remanded a decision for the reinsurer stating:

> [T]here is no clear-cut anti-annualization language in the [facultative] certificates. . . . [A]bsent a clear limitation in the certificates, the principle of congruent liability between cedent and reinsurer – adopted by [the cedent and reinsurer] in the certificates' follow-the-form and follow-the-settlements clause . . . suggests that [the reinsurer's] liability should follow the gloss . . . given to the underlying policies by the settlement.[5]

A tower of multi-year insurance and reinsurance agreements for W. R. Grace was involved in *Commercial Union Ins. Co. v. Swiss Reinsurance American Corp.* 413 F. 121 (1st Cir. 2005). The primary policy clearly annualized aggregate limits but the excess policy suggested non-annualized aggregate limits. Nonetheless, the excess insurer settled claims based on an annualized aggregate. The court reversed and remanded the district court decision for the reinsurer. The court found that the follow the form clause in the excess policy and the reinsurance certificate trumped the anti-annualized language in the excess policy.

A three-year policy clearly called for annualization of aggregate limits but it was less clear in the facultative certificate in *Travelers Casualty & Surety Co. v. Ace American Reinsurance Co.*, 201 Fed. Appx. 40 (2nd Cir. 2006). The court ruled: "The follow the form clause [in the facultative certificate] required the district court to presume that the liability limits of the Certificates applied in the manner concurrent with those of the Policies."[6]

IV. Expenses Within or In Addition to Limits in Facultative Certificates

Global Reinsurance Corp. of America v. Century Indemnity Co., 442 F. Supp. 3d 576 (S.D. N.Y. 2020) involved a policy that paid expenses in addition to limits via a supplementary payments clause and a facultative certificate that contained a follow the form clause. The court found that the facultative certificate was obligated to pay expenses in addition to limits as a result of the follow the form clause:

> The Following Form Clause states that [the reinsurer's] liability is "subject in all respects to all the terms and conditions of the [the cedent's] policy." "[A]ll the terms and conditions" includes the Supplementary Payments provision in the [cedent's] Policies, states that that insurer must pay expenses in addition to the limit of liability.[7]

Utica Mutual Insurance Co. v. Munich Reinsurance America, inc., 2021 U.S. App. LEXIS 22476 (2nd Cir. 2021) involved a 1973 umbrella policy and facultative certificate. Originally the umbrella paid expenses within limits but it was amended in 1974 to pay expenses in addition to limits for drop-down coverages (*e.g.* false arrest) not covered by the primary policy. There was no corresponding change in the facultative certificate which had a follow the form clause. The court ruled that the drop-down coverage was outside the scope of the primary policy and the excess policy reinsured by the facultative certificate. Therefore the reinsurer's obligation was to pay expenses within limits under the original umbrella policy.

V. Coverage for Risk Not Included in or Excluded from Cession to Reinsurer

United Fire & Casualty Co. v. Arkwright Mutual Ins. Co., 53 F. Supp. 2d 632 (S.D. N.Y. 1999) involved a reinsurance cession that did not include the entire primary risk. The risk in question was an extended period of liability endorsement which was not originally of the part business interruption policy for which liability was ceded to the reinsurer. The loss occurred before the submission oversight was discovered. The court ruled that the follow the form clause in the facultative certificate did not create coverage for a risk not part of the original submission.

The insurer's policy included a $25,000 self-insured retention with a quota share facultative cession of risk in excess of the SIR in *Calvert Fire Insurance Co. v. Yosemite Insurance Co.,* 573 F. Supp. 27 (E.D. N.C. 1983). When the insured became bankrupt, the cedent was obligated to pay claims within the SIR. The cedent brought an action to recover reinsurance recoverables within the SIR pursuant to the follow the form clause. The court found for the reinsurer on the basis that coverage within the SIR was not part of the cession to the reinsurer.

Gencorp, Inc. v. American International Underwriters, 178 F. 3d 804 (6th Cir. 1999) involved a captive umbrella insurer and excess layers, which included follow the form clauses, above the umbrella. The insured brought an action for coverage for pollution losses against its captive and the excess insurers. This action was settled by payment of $20 million by the captive in return for an exclusion of pollution losses retroactive to inception of the policy. When another pollution loss occurred, the insured attempted to collect from the excess insurers alleging, among other things, a lack of consideration from the excess insurers for application of the retroactive pollution exclusion to the excess insurers. The court found for the excess insurers ruling:

> [I]t is immaterial that the Excess Insurers did not participate in the $20 million settlement of the [prior pollution claim] and that the parties to the Settlement Agreement did not intend to confer any benefit on third parties because the Excess Insurers and [the insured] *did intend* for the Excess Policies to ***follow the form*** of the underlying [captive umbrella] policies, including future changes.[8]

VI. Comments

The follow the form clause is a uniquely simple and efficient means of assuring concurrency of coverage in a tower of insurance and reinsurance. Concurrency of coverage has been recognized by the courts as a custom and practice of the industry. It is a very effective means of tying excess and reinsurance coverage to that provided by underlying contracts.

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1 *Global Reinsurance Corp. of America v. Century Indemnity Co.*, 442 F. Supp. 3d 576, 582 (S.D. N.Y. 2020).

2 *Id.* at 583.

3 *Aetna Casualty & Surety Co. v. Home Insurance Co.*, 882 F. Supp. 1328, 1337 (S.D.N.Y. 1995).

4 Quoting *Unigard Security Ins. Co. v. North River Ins. Co.,* 4 F. 3d 1049, 1053 (2nd Cir. 1993).

5 413 F. 3d 129, 138.

6 201 Fed. Appx. 40, 41.

7 442 F. Supp. 576, 587.

8 178 F. 3d 804, 812 (emphasis in the original).