

Second Circuit Confirms: Follow the Settlements Does Not Create Coverage

By

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I. Introduction

There are substantial policy reasons behind the custom and practice of follow the settlements (or fortunes) with respect to recoveries by primary insurers from their reinsurers. However, it can be used as a lever in an attempt to create coverage that was never part of the original reinsurance placement. The purpose of this article is to review a recent second circuit case on point plus related caselaw. In the interests of full disclosure, the author was an expert witness for the reinsurer on follow the settlements and other issues.

II. **Utica Mutual Insurance Company v. Fireman's Fund Insurance Company**¹

A. Fact Situation

Utica Mutual sold a series of primary general liability and umbrella policies to Goulds Pumps. Some of their pumps contained asbestos which generated a flood of claims. Fireman's Fund facultatively reinsured Utica Mutual's umbrella policies from 1966 to 1972. The central issue was whether or not the general liability policies contained a liability aggregate.

Without an aggregate, Utica Mutual would be liable to pay so many individual claims within the primary limit as to render the insurer insolvent. Therefore, it was vital for Utica Mutual to prove aggregates on the primary policies in order to penetrate the umbrellas which were heavily reinsured. Unfortunately for Utica Mutual, the primary policies and policy files for this period were lost and virtually nothing that could be found in Utica Mutual's umbrella policies or their underwriting files that supported aggregate liability limits in the underlying policies. (Ironically, the umbrella did reference underlying property aggregates.) Likewise, nothing in

Fireman’s Fund facultative certificates or underwriting files evidenced liability aggregates in the underlying policies. Therefore, Utica Mutual took a number of steps to support its argument for aggregate limits in the liability policies.

In litigation with Union Mutual, the insured, Goulds Pumps, argued that there were no liability aggregates in the policies. However, Utica Mutual paid Goulds a hefty premium for a settlement that recited the presence of liability aggregates and their exhaustion. Reinsurers became aware of this settlement only much later.

“Virtual” policy files were created which started with the assumption that the policies included liability aggregates and then worked backwards to include bits and pieces of documents that seemed to support that assumption. An expert witness made the argument that during the 1966 to 1972 time period, insureds simply understood that commercial liability policies contained a liability aggregate limit plus the amount of the limit, regardless of whether it was so stated in the declarations of the policies. And so it went.

Nonetheless, after a trial in Utica, New York, the jury found for Utica Mutual.

B. The Appeal

On appeal, the second circuit rejected a Utica Mutual argument that only occurrence limits had to be scheduled in the umbrella (effectively eliminating the per person, per accident and property aggregate limits) allowing Utica Mutual to allocate bodily injury losses to the umbrella policy that exceeded scheduled limits. *Utica Mutual Ins. Co. v. Fireman’s Fund Ins. Co.*, 2020 U.S. App. LEXIS 13579*15-16. The court thus preserved the scheduled limits of Utica Mutual’s umbrella policy, which did not reflect a liability aggregate in the underlying policies.

The court then turned to Utica Mutual’s argument “that even if Fireman’s Fund is not actually liable for Utica’s losses, Firemen’s Fund is obligated by the follow the settlements clauses in the reinsurance contracts to accept Utica’s interpretations of the umbrella policies . . .”² While

acknowledging the benefits of the custom and practice of follow the settlements, the court ruled that it cannot be used to alter or override the terms of the reinsurance agreement. In rejecting Utica Mutual's position, the court ruled:

Here, Utica's theory directly contradicts the relevant language in the reinsurance contracts and umbrella policies. . . . [A] reinsurer cannot be held accountable for an allocation that is contrary to the express language of the reinsurance policy. Utica's reading would essentially render the follow the form clause in the reinsurance contract and the umbrella policy language defining Utica's loss meaningless and "would be contrary to the parties' express agreement and to the settled law of contract interpretation."³

III. Prior Caselaw

Travelers Casualty & Surety Co. v. Gerling Global Reinsurance Corp. of Amer., 419 F.3d 181 (2nd Cir. 2005) was an asbestos allocation case. Travelers was in a dispute with its insured over products vs. non-products losses and number of occurrences. The dispute was settled in a fashion roughly equivalent to two occurrences but its claim for reinsurance recoverables was based on one occurrence. The reinsurers argued that it should not be liable for a post-settlement allocation at variance with Traveler's pre-settlement position of one occurrence. The court distinguished between a dispute in which the reinsurer is challenging coverage from one in which the issue is not coverage but allocation. The court found for the cedent ruling: "A reinsurer undoubtedly 'cannot be held accountable for any loss not covered by the reinsurance policy,' but if a loss is covered by several policies, a good-faith reasonable allocation among those policies cannot violate their terms."⁴

Coverage for punitive damages was the issue in *American Insurance Company v. North American Company for Property & Casualty Ins. Co.*, 697 F.2d 79 (2nd Cir 1982). The policy at issue did not cover punitive damages. A jury awarded damages against the insured with the majority consisting of punitive damages. The dispute was settled while on appeal. The reinsurer argued that it did not cover punitive damages and when the settlement was reduced by an amount

applicable to punitives, it did not reach the attachment point of the excess of loss reinsurance. The court rejected the cedent's follow the fortunes argument:

This disagreement between [the cedent and reinsurer] reflects the inherent tension between "follow the fortunes" clauses and limitations on the liability of reinsurers. In some cases in which there is genuine ambiguity over what a settlement covers a "follow the fortunes" clause may oblige a reinsurer to contribute to a settlement even though it might encompass excluded items. . . . [But] [i]t is clear that the settlement here was primarily designed to compensate [the insured] for a punitive damage award that is excluded from this reinsurance policy.⁵

A relevant state court case is *Travelers Casualty & Surety Co. v. Certain Underwriters at Lloyd's of London*, 760 N.E.2d 319 (N.Y. 2001). This was the consolidation of two appeals involving pollution-related losses over many years, for many sites and under many policies. The cedent attempted to consolidate each loss into a single "disaster and/or casualty" covered by the relevant treaties. The court found that the definitions in the relevant contracts did not support such an interpretation. In addition, the court rejected the cedent's follow the settlements arguments:

To hold that these "follow the fortunes" clauses supplant the definition of "disaster and/or casualty" in the reinsurance treaties and allow Travelers to recover under its single allocation theory would effectively negate the phrase. The practical result of such an application would be that a reinsurance contract interpreted under New York law contains a "follow the fortunes" clause would bind a reinsurer to indemnify a reinsured whenever it paid a claim, regardless of the contractual language defining loss.⁶

IV. Commentary

While the second circuit seems to be willing to grant ceding insurers considerable leeway in pure allocation disputes, such is not the case in coverage disputes. The doctrine of follow the settlements (or fortunes), does not create coverage where none is otherwise demonstrable.

ENDNOTES

¹ 2020 U.S. App. LEXIS 13579 (2nd Cir.).

² 2020 U.S. App. LEXIS 13579*19.

³ *Id.* at *21 (internal citations omitted).

⁴ 419 F.3d 181 at 194.

⁵ 697 F.2d 79 at 81.

⁶ 760 N.E.2d 319 at 329.