

Reinsurance

'Follow the Settlements' And Allocation: A Review Of Recent Developments

by
Amy M. Rubenstein, Esq.

Schiff Hardin, LLP
Chicago

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Commentary

'Follow the Settlements' And Allocation: A Review Of Recent Developments

By
Amy M. Rubenstein¹

[Editor's Note: Ms. Rubenstein is an associate with Schiff Hardin in Chicago. She handles a wide range of cases, such as general commercial and corporate disputes, reinsurance, intellectual property and federal constitutional law. Replies to this commentary are welcome. Copyright 2007, Schiff Hardin LLP.]

This article considers recent United States case law, which sets forth the analytical framework employed by courts in applying the follow the settlements doctrine to a cedent's allocation decision. These cases suggest that the proper standard depends, in large part, on whether the applicable reinsurance is facultative or treaty and, further, appear to reflect a new willingness by at least some courts to more closely examine underlying settlement and allocation determinations.

Introduction

Especially in cases involving mass torts, an insurer's first order of business after settling with its insured frequently is to decide how to allocate that settlement to its reinsurers. This process usually requires an analysis of how to spread that settlement across policy years and, thus, requires a determination of the number of "occurrences" involved, the relevant policy periods, and/or the possibility of annualization. Confronted with allocations that seem to maximize reinsurance liability, it has not been uncommon for reinsurers to challenge the cedent's allocation. The cedent often responds by arguing that the reinsurer is bound by the cedent's allocation decision under the "follow the settlements" doctrine.

Follow the settlements, a narrower version of the follow the fortunes doctrine,² generally prohibits a reinsurer from challenging a cedent's claim payment decisions, so long as the cedent acted reasonably, in good faith and within the relevant policies.³ The doctrine originally evolved for a number of policy reasons that still influence the case law today. Initially, achieving the best settlement possible served both the cedent's and the reinsurer's interests. This common interest gained further support from the long-standing relationships between the cedents and reinsurers, in which reinsurers avoided allocation disputes to maintain a positive business relationship with their cedents.⁴

Unfortunately, reinsurers' and cedents' interests frequently diverge, which may call into question the rationale of strictly following settlements in all circumstances. Nonetheless, courts continue to apply the cedent-friendly doctrine to allocation decisions, citing the importance of certainty and expediency in settlement agreements. Courts have also expressed the concern that, absent follow the settlements, cedents would litigate allocation issues before settling, resulting in large unpaid claims and increased docket congestion.

The seminal case applying follow the settlements to allocation is *Commercial Union v. Seven Provinces*.⁵ In that case, a federal district court in Massachusetts held 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."⁶ Attempting to avoid

the follow the settlements doctrine, Seven Provinces asserted that it only challenged “the good faith of the allocation, rather than the settlement.” The court disagreed, and found that Seven Provinces’ settlement-versus-allocation argument was “a distinction without a difference.”⁷ The court stated that:

[T]he attempt to distinguish settlement from allocation would undermine the entire ‘follow the settlements’ doctrine. In practical terms, the determination of which among several policies covers which particular loss among many is not much different from the more general decision that the losses are covered by the policies.⁸

The court also noted that “it would be impossible for [the cedent] to come to any settlement of such complex claims . . . If the ‘follow the settlements’ principle did not apply to the allocation of those settlements, litigation would surely proliferate.”⁹ The *Seven Provinces* decision has not settled the issue.

More recent decisions underscore the distinction between facultative and treaty reinsurance in determining whether a reinsurer must follow the cedent’s allocation decision. In the case of facultative reinsurance, where the certificate is often a one or two page standard form with coverage terms following the underlying insurance policy, courts generally require a reinsurer to follow the cedent’s decisions as long as the settlement allocation is reasonable, in good faith, and arguably within the policy.¹⁰ This situation is distinguished from treaty reinsurance, which involves a detailed contract covering numerous, varied policies, and containing its own coverage terms and conditions, often distinct from those in the underlying policies. The treaty’s terms govern whether the cedent’s allocation is allowed. This distinction has been noted by two recent cases.¹¹ Nonetheless, at least one court recently deviated from this general rule.

Follow The Settlements In Facultative Reinsurance

North River v. ACE (2d Cir. 2004)

Building on the foundation laid by *Seven Provinces*, the Second Circuit affirmed the Southern District of New York’s reliance on that decision in *North River v.*

ACE.¹² In upholding the reinsurer’s indemnification obligation, the Second Circuit held:

[T]he follow-the-settlements doctrine extends to a cedent’s post-settlement allocation decisions, regardless of whether an inquiry would reveal an inconsistency between that allocation and the cedent’s pre-settlement assessments of the risk, as long as the allocation meets the typical follow-the-settlements requirements, *i.e.*, is in good faith, reasonable, and within the applicable policies.¹³

Here, ACE provided facultative reinsurance for a portion of North River’s policies with Owens-Corning Fiberglass Corporation (“OCF”).¹⁴ Litigation arose concerning North River’s obligations to OCF for asbestos-related claims.¹⁵ During this litigation, North River examined a variety of ways that OCF’s claims could be covered: “[a]t one point, North River’s preliminary decision tree analysis set forth 83 different, probability-weighted, damage and coverage scenarios.”¹⁶ Eventually, North River and OCF settled, and North River billed ACE for its share.¹⁷

ACE disputed “the settlement allocation because North River assigned its entire settlement to ACE’s layer of reinsurance . . . even though North River’s pre-settlement analysis of possible litigation outcomes identified risk of loss in higher layers.”¹⁸ ACE further argued that “North River’s interests in allocating the loss to it are in conflict with those of ACE and thus a fundamental premise of the follow-the-settlements, mutuality of interest, is missing.”¹⁹ The court rejected the latter argument, observing that “the main rationale for the doctrine is to foster the ‘goals of maximum coverage and settlement’ and to prevent courts through ‘de novo review of [the cedent’s] decision-making process’ from undermining ‘the foundation of the cedent-reinsurer relationship.’”²⁰ The court further explained that:

[I]t is precisely this kind of intrusive factual inquiry into the settlement process, and the accompanying litigation, that the deference prescribed by the follow-the-settlements doctrine is designed to prevent. Requiring post-settlement allocation to match pre-settlement analyses

would permit a reinsurer, and require the courts, to intensely scrutinize the specific factual information informing settlement negotiations, and would undermine the certainty that the general application of the doctrine to settlement decisions creates.²¹

Importantly, the court did note that this holding does not leave the reinsurer without protection: the requirements of reasonableness, good faith, and coverage within the terms of the policy still apply.²²

Travelers v. Gerling (2d Cir. 2005)

Coverage of OCF's asbestos-related claims was also at issue in *Travelers v. Gerling*, wherein the Second Circuit relied on its *North River* position.²³ Traveler's insured OCF and settled certain claims.²⁴ Like *North River*, Travelers obtained facultative reinsurance for a portion of the OCF risk with Gerling Reinsurance Corporation ("Gerling").²⁵ When Travelers billed Gerling for its share of the OCF settlement, Gerling opposed Travelers' allocation.²⁶ Gerling "insisted that the allocation be made on a multiple-occurrence, rather than a single-occurrence, basis."²⁷

The court would not, however, entertain further judicial inquiry into the allocation. Citing many of the passages from *North River* quoted above, the Second Circuit determined that Gerling's position was even weaker than ACE's because, unlike *North River*, Travelers did not document alternative pre-settlement allocation theories.²⁸ Moreover, the court stated *five* times that "OCF and Travelers 'explicitly disclaimed any particular theory of coverage,' as they never reached agreement as to whether the claims arose from a single occurrence or multiple occurrences."²⁹ Rather than relying on written settlement documents, the only inquiry the court allowed was whether the settlement was reasonable, in good faith and within the relevant policies.

Notably, the Second Circuit distinguished between the application of follow the settlements to facultative and to treaty reinsurance.³⁰ The court refused Gerling's request to rely on a previous case involving treaty reinsurance, *Travelers v. Lloyd's*, which held that follow the settlements "did not apply to the cedent's post-settlement allocation because the allocation did not fall within the treaties' terms."³¹ The Second Circuit stated that:

[Travelers v.] Lloyd's involved reinsurance treaties rather than facultative certificates . . . and those treaties contained their own definitions of 'loss' and 'disaster,' which were distinct from the coverage terms of the underlying policies . . . The Lloyd's treaties, in other words, were distinguishable from Gerling's reinsurance certificates, which did not contain an independent definition of 'occurrence.'³²

Commercial Union v. Swiss Re and American Employers' v. Swiss Re (1st Cir. 2005)

Two companion cases from the First Circuit further refined the bounds of the follow the settlements doctrine to allocation decisions: *Commercial Union v. Swiss Re*³³ and *American Employers' v. Swiss Re*.³⁴ In both cases, Swiss Re challenged the cedents' settlement allocation. The First Circuit applied follow the settlements in both cases, but remanded to the district court with either the instruction or the suggestion to examine the good faith and reasonableness of the settlement. While other courts mentioned that a review of good faith and reasonableness *could* be done, the First Circuit indicated in these cases that it *should* be done on remand.

Commercial Union v. Swiss Re (1st Cir. 2005)

In *Commercial Union v. Swiss Re*, Commercial Union insured Grace & Co. ("Grace") under multiple multi-year policies,³⁵ and reinsured a portion of that risk with Swiss Re under a number of facultative certificates that included a per-occurrence limit, a follow the forms clause and a follow the settlements clause.³⁶ The certificates, however, did not define "occurrence."³⁷ After settling with Grace on an annualized basis,³⁸ Commercial Union sought indemnity from Swiss Re, applying its per-occurrence limit in each policy separately for each policy year.³⁹ Swiss Re refused full payment and argued that the facultative certificates prohibited annualization, because the per-occurrence limit applied for the whole multi-year period.⁴⁰

The court agreed with Commercial Union's pro-annualization reading of its policies with Grace.⁴¹ Relying on the follow the form clause, the court stated that only a "clear limitation to the contrary in the Swiss Re documents" could prevent Commercial Union's annualization.⁴² The First Circuit explained:

This view of the matter accords with the basic presumption of concurrence that we think exists where there is a skeleton reinsurance contract coupled with follow-the-form and follow-the-settlement clauses . . . Of course, if sufficiently clear, specific limits in the certificate control over the general aim of concurrence and ordinary 'follow' clauses.⁴³

The court held that where a limit or condition is "simply cryptic . . . the balance is tipped in favor of making [the reinsurer] share liability."⁴⁴ Thus, even though the reinsurer had an argument for non-annualization based on a possible interpretation of the certificate, the court declined inquiry by labeling the policy language "cryptic" and unclear.

American Employers' v. Swiss Re
(1st Cir. 2005)

This same basic rule was applied in *American Employers' v. Swiss Re*.⁴⁵ American insured Pennsalt Chemical Company ("Pennsalt") through three multi-year policies, that were reinsured by Swiss Re through three multi-year facultative reinsurance certificates similar to those in *Commercial Union*, i.e., skeletal in form, containing occurrence and aggregate limits, follow the form and follow the settlements clauses.⁴⁶

Pennsalt's parent company, Elf, made a claim on the American policies after settling a number of hazardous waste suits. During settlement negotiations, Elf based its demands on a non-annualization theory of its multi-year policies and American based its offers on an annualization approach.⁴⁷ Through mediation, American determined that "there was little difference between Elf's non-annualized approach and American's annualized approach 'as far as the final liability number was concerned,'" so they settled under an agreement containing no mention of annualization.⁴⁸ American then billed Swiss Re based on an annualized basis for the multi-year facultative reinsurance.⁴⁹

Swiss Re denied payment, asserting, among other things, that the per-occurrence limits in the certificates precluded annualization.⁵⁰ The court highlighted that "the settlement American actually paid was based on a calculation of its own liability that did assume annualization," even though the settlement did not expressly address that issue.⁵¹ It was also

noted that the allocation method was "not a post-hoc characterization or a unilateral post-settlement allocation without grounding in the settlement process itself." However, the court left open for "Swiss Re to challenge American's good faith on remand if it has evidence to support such a claim."⁵²

Interestingly, in suggesting this inquiry, the court distinguished its view — that consistent pre- and post-settlement allocation methods are a "starting point" for an analysis of good faith and reasonableness — from that of the courts in *North River* and *Seven Provinces*. In footnote 8 of the opinion, the First Circuit declined to approve American's argument that "regardless of what the settlement embodies, a cedent's unilateral post-settlement decision as to allocation among reinsurance policies is binding under a follow the settlements clause."⁵³ This footnote signals that courts may hesitate to apply follow the settlements to a cedent's post-settlement allocation that differs from its pre-settlement assessment. Such discrepancies seem to factor into the good faith and reasonableness inquiries.

The First Circuit in *American* ultimately held that the certificate did not prevent annualization:

Absent a clear limitation in the certificate, the principle of congruent liability between cedent and reinsurer-adopted by Swiss Re and American in the certificates' follow-the-form and follow-the-settlements clauses . . . suggests that Swiss Re's liability should follow the gloss (assuming it is reasonable and made in good faith) given to the underlying policies by the settlement.⁵⁴

Though the court did not conduct the good faith and reasonableness inquiry, the case was remanded for such an examination, with the court suggesting that "the parties would be well advised to settle."⁵⁵

**Facultative Case Law Examining
Good Faith And Reasonableness**
National Union v. American Re
(S.D.N.Y. 2006)

As in *Commercial Union* and *American Employers'*, courts have suggested that they are willing to examine whether a settlement allocation is reasonable

and in good faith. *National Union v. American Re* is among three recent cases involving an actual, detailed inquiry into the limitations of applying follow the settlements to an allocation decision.⁵⁶ In this case, the Southern District of New York rejected American Re's challenge to National Union's settlement allocation, applying follow the settlements doctrine and citing *Travelers v. Gerling*.⁵⁷ American Re questioned whether the cedent's settlement was within the relevant policies, reasonable and in good faith, where the cedent accepted the insured's allocation method.⁵⁸

First, with respect to coverage, the court found that the follow the fortunes doctrine requires American Re to indemnify National Union's claim payment so long as it "was at least *arguably* within the scope of the insurance coverage that was reinsured."⁵⁹ Citing documentary evidence that suggested coverage, the court held that a reasonable factfinder could only determine that the payment was at least *arguably* within the policy.⁶⁰

Then, this coverage finding — that the allocation was "at least arguably correct" — led the court to determine that the allocation likewise satisfied the reasonableness requirement. The court noted that American Re's argument that National Union acted unreasonably in accepting the insured's allocation method "must fail because it is exactly the type of inquiry that the follow-the-fortunes doctrine is intended to prevent"; allowing such an inquiry "would be to make settlement impossible and reinsurance in itself problematic."⁶¹

Finally, American Re argued that National Union acted in bad faith because "National Union was indifferent to the improper allocation of plaintiffs to the reinsured policy, and that it intentionally turned a blind eye to maximize its reinsurance recovery."⁶² In rejecting this argument, the court stated that:

[A] cedent choosing among several reasonable allocation possibilities is surely not required to choose the allocation that minimizes its reinsurance recovery to avoid a finding of bad faith. . . . An allocation that increases reinsurance recovery—when made in the aftermath of a legitimate settlement and when cho-

sen from multiple possible allocations—would rarely demonstrate bad faith in and of itself.⁶³

The court held that even indifference to a proper allocation would not rise to a showing of "extraordinary bad faith."⁶⁴ Thus, the reinsurer was unable to meet the high standard for challenging the cedent's settlement allocation.

Suter v. General Accident (D.N.J. 2006)

Nonetheless, the reinsurer has prevailed in at least two recent decisions in the facultative realm: *Suter v. General Accident*⁶⁵ and *Allstate v. American Home*.⁶⁶ The *Suter v. General Accident* ("Suter") opinion, however, was vacated by the New Jersey District Court in May, 2007 as a result of a settlement between the parties.⁶⁷ Though this opinion no longer has authority as precedent, it still provides instruction on how courts review allocation decisions.⁶⁸ The *Suter* court held that, because the insurer was grossly negligent in its settlement of the relevant claims, "the defendant has met its burden by a preponderance of the credible evidence that it is not obligated to follow the fortunes or settlements of [the cedent]."⁶⁹

In *Suter*, Integrity Insurance Company insured Pfizer, and reinsured a portion of the Pfizer risk with General Accident under facultative certificates that covered Integrity on an occurrence basis and included follow the settlements language.⁷⁰ Integrity paid claims submitted by Pfizer, and then billed General Accident for a portion of those claims.⁷¹ General Accident refused payment, because, amongst other things, it argued that the settlement did not fall within the policies, was unreasonable and in bad faith.⁷²

"Bad faith in this context amounts to a showing of gross negligence, recklessness or a showing that the settlement was not even arguably within the scope of the reinsurance coverage."⁷³ As General Accident had only insured Integrity for two years and only for occurrences during that period, Integrity had to show that the claims met these requirements. However, there was no evidence that any theory Integrity used to allocate its claims to General Accident's policy period was ever legally valid.⁷⁴ Because it deemed Integrity's coverage rationale unfounded, the court held that the claims did not fall within General Accident's policy period.

Even though the claims were outside the policy, the relevant inquiry for follow the settlements to apply “is not whether the claims are within the policy but whether the claims are *reasonably* within the terms of the policy.”⁷⁵ To meet this standard, Integrity should have made a good faith and reasonable, businesslike investigation, which it did not. The court found that: Integrity accepted, without independent assessment, Pfizer’s classification of the claims; Integrity’s claims examiner requested further medical evidence but never received it; and Integrity failed to obtain its own coverage counsel, even when multiple documents that the claims examiner received suggested there was new case law pertinent to the claims.⁷⁶ Therefore, the claims were not “even arguably within the terms of Integrity’s policy.”⁷⁷ *Suter* illustrates that a reinsurer can successfully challenge the cedent’s allocation, but the cedent’s conduct must be highly inappropriate.

**Allstate v. American Home
(N.Y. App. Div. 2007)**

*Allstate v. American Home*⁷⁸ represents another successful challenge to a cedent’s allocation. In *Allstate*, American Home provided commercial property insurance to United Technologies Corporation (“UTC”).⁷⁹ UTC sued American Home in Connecticut District Court for indemnification from environmental pollution damage at sixteen different sites.⁸⁰ Both UTC and American Home maintained that each site involved multiple occurrences, but they disagreed as to how many occurrences per site.⁸¹

With respect to one site, the Connecticut District Court found seven occurrences. American Home disagreed and moved for a new trial, but the parties settled without resolving the number of occurrences issue.⁸² However, the litigation continued regarding coverage on the sixteen sites, and American Home consistently assessed its exposure at each of the sites on a “multiple-occurrence-per-site” basis.⁸³ Before the trial regarding the sixteen sites, American Home and UTC settled. American Home’s settlement position was that there were ninety-five occurrences, while UTC maintained there were only forty-four occurrences.⁸⁴

After settling, American Home asked its litigation counsel, who had never allocated an environmental coverage settlement to reinsurers, to prepare an analysis to allocate the settlement to American Home’s reinsur-

ers.⁸⁵ This analysis resulted in American Home billing its reinsurers on a “one-occurrence-per-site-per-year” basis, thus triggering Allstate’s facultative reinsurance certificates.⁸⁶ Allstate brought a declaratory judgment action and sought partial summary judgment that “it was not bound to the follow-the-fortunes doctrine because [American Home’s] reinsurance loss allocation of the [] sites was unreasonable.”⁸⁷

While American Home relied on *North River v. Ace* and *Travelers v. Gerling* (discussed above) to argue that Allstate must accept the allocation, the court held those cases:

[D]o not require a reinsurer, under the follow-the-fortunes doctrine, to accept the reinsured’s post-settlement loss allocation even if that allocation is contrary to the reinsured’s pre-allocation position and treatment of the loss allocation issue with its own insured, i.e., its treatment of deductibles. While the cases unequivocally hold that the doctrine extends to a post-settlement allocation despite ‘an inconsistency between that allocation and the [reinsured’s] pre-settlement assessments of risk,’ it applies only ‘as long as the allocation meets the typical follow-the-settlements requirements, i.e., is in good faith, reasonable, and within the applicable policies.’ Here, unlike *North River*, the inconsistency is not between defendant’s post-settlement allocation and its pre-settlement assessments of the risk, but between its pre-settlement allocation of loss with its insured (UTC) and its post-settlement allocation with its reinsurer.⁸⁸

The court found that the settlement allocation was unreasonable and in bad faith because: (1) the one-occurrence-per-site allocation directly contradicted the Connecticut District Court’s ruling that at least one of the sites had seven occurrences; (2) the reinsurance allocation was internally inconsistent; and (3) it reflected “an effort to maximize unreasonably the amount of collectible reinsurance.”⁸⁹ In the court’s view:

The follow-the-fortunes doctrine was intended to foster consistency in the treatment of losses at both levels, insured and

reinsured, not to allow an insurer to use a different set of rules at each level. [The court] soundly reject[s] the notion that the follow-the-fortunes doctrine requires that courts turn a blind eye to such manifest manipulation of the allocation process in total disregard of the reinsured's obligation to act in good faith.⁹⁰

The court distinguished this case as “unlike any other reported case involving the follow-the-fortunes doctrine, [in that] defendant ignored a court ruling determining the number of occurrences at a covered site in its allocation of loss to plaintiff, and instead imposed a single occurrence at the [] site for reinsurance purposes.”⁹¹ Notably, the court concluded that American Home's “inconsistent handling of loss is the very antithesis of the follow-the-fortunes doctrine.”⁹²

Follow The Settlements In Treaty Reinsurance

Judicial review of an allocation to treaty reinsurance differs significantly from that of a facultative certificate containing form following provisions. The two leading cases in treaty reinsurance allocation are *Travelers v. Lloyd's*⁹³ and *Hartford v. ACE*.⁹⁴ In both cases, the courts analyzed the meaning of the terms contained in the treaty reinsurance and held that the reinsurer was not bound to accept the cedent's allocation decision when such allocation was inconsistent with the treaty.

Travelers v. Lloyd's (N.Y. 2001)

In *Travelers v. Lloyd's*, Travelers provided various forms of insurance for Koppers and DuPont.⁹⁵ Travelers reinsured portions of these risks with various London reinsurers.⁹⁶ These reinsurance treaties obligated “the reinsurers to pay Travelers for ‘each and every loss’ incurred by Travelers that exceeds the retentions established under the treaties.”⁹⁷ The treaties defined “each and every loss,” “disaster and/or casualty,” and included a follow the fortunes clause.⁹⁸ Travelers settled a number of pollution claims with both companies, and treated each contamination site as a separate occurrence with respect to its insureds.⁹⁹ Then, Travelers billed the reinsurers by treating all 160 Koppers contamination sites as one loss and all 25 DuPont contamination sites as one loss.¹⁰⁰

The reinsurers rejected this allocation and argued that Travelers' aggregation of all the claims into one oc-

currence for each insured was contrary to the terms of the treaty reinsurance agreement.¹⁰¹ Travelers argued that:

The allocations . . . in the Koppers and DuPont settlements for reinsurance purposes were premised on the theory that pollution at the various sites had a ‘common origin’ or was ‘traceable to the same mistake,’ namely Koppers' deficient corporate environmental policy and DuPont's failure to implement and enforce its environmental policy.¹⁰²

In support of this theory, Travelers cited a British case requiring occurrence to have the broadest definition possible.¹⁰³ After analyzing the treaty, the court rejected this argument and held that the single allocations do not fall within the ambit of “disaster and/or casualty” as provided in the reinsurance treaties.¹⁰⁴

Travelers argued that even so, the follow the fortunes clause “mandate[s] that the reinsurers reimburse it for losses it allocates to them reasonably and in good faith.”¹⁰⁵ While the court agreed with the rule, it found that it was inapplicable in the present case:

While a follow the fortunes clause in most reinsurance agreements leaves reinsurers little room to dispute the reinsured's conduct of the case, we agree with the rationale of the . . . Second Circuit that such a clause does not alter the terms or override the language of reinsurance policies.¹⁰⁶

The court further supported its analysis by stating:

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 that contains a ‘follow the fortunes’ clause would bind a reinsurer to indemnify a reinsured when-

ever it paid a claim, regardless of the contractual language defining loss.¹⁰⁷

Unlike facultative reinsurance cases, where courts typically apply follow the fortunes unless the certificate language contains clear, specific limits, as seen in this case, courts are more willing to engage in a detailed analysis of reinsurance treaties. This occurs because reinsurance treaties are extensive contracts with their own terms and definitions, which do not simply follow the form of an underlying insurance policy to define coverage.

Hartford v. ACE (Conn. Super. Ct. 2005)

In *Hartford v. ACE*, the Superior Court of Connecticut relied on this rationale to decide in favor of the reinsurer on a motion for summary judgment.¹⁰⁸ Hartford insured MacArthur Company, whose primary business was installing asbestos insulation.¹⁰⁹ Hartford, MacArthur and a number of other parties settled over 17,000 asbestos claims by an agreement to which Hartford contributed.¹¹⁰ Like Travelers, Hartford claimed that “the 17,000 separate claims filed by individuals against MacArthur of dispersed work sites, over the course of four decades with respect to various operations by MacArthur in installing asbestos insulation, constitute ‘one accident’ pursuant to the language of the policies.”¹¹¹ When the reinsurers refused payment, Hartford brought suit claiming that follow the settlements required acceptance of its allocation.

Citing *Travelers v. Lloyd's*, the court denied applicability of the follow the fortunes doctrine.¹¹² The court held that the agreement between the parties dictated, and that follow the fortunes would not override the express intent of the parties to limit liability. Additionally, the court distinguished *North River* from the present Hartford claim largely because “the reinsurance contract at issue in *North River* was a facultative certificate without independent contractual terms to govern the post-settlement allocation.”¹¹³ The court thus held that, because there is an “independent definition of occurrence . . . the follow the fortunes doctrine [is] inapplicable . . . and the London reinsurers are not bound by either the prior settlement decision or the post-settlement allocation of Hartford.”¹¹⁴ In so holding, the court underscored that the Second Circuit in *Travelers v. Gerling* distinguished between treaty and facultative reinsurance in determining

whether follow the settlements applies to an allocation decision.¹¹⁵

The Outlier

Argonaut v. Travelers (N.Y. Sup. Ct. 2005)

One case has been found that does not follow the developing pattern. In *Argonaut v. Travelers*, a lower New York court did not apply follow the settlements to Travelers’ settlement allocation on facultative reinsurance certificates.¹¹⁶ Travelers insured Witco and paid it for environmental pollution claims.¹¹⁷ Travelers’ facultative reinsurers refused to honor Travelers’ bill to them for the settlement, on the grounds that the allocation contradicted Travelers’ previous treatment of the settlement.¹¹⁸

Rather than examining whether Travelers’ allocation was reasonable, in good faith, and arguably within the policy, the court substantially departed from the way in which other courts analyze follow the settlements as applied to facultative reinsurance allocations. Citing *Travelers v. Lloyd's*, a case involving treaty reinsurance,¹¹⁹ the court conducted an in-depth factual inquiry regarding the settlement allocation.¹²⁰ However, this seems to be “precisely [the] kind of intrusive factual inquiry into the settlement process, and the accompanying litigation, that the deference prescribed by the follow-the-settlements doctrine is designed to prevent.”¹²¹ This caused the court to determine that the definition of “occurrence” contained in the underlying policy precluded Travelers’ allocation method.

Key to the decision was evidence that the post-settlement single-occurrence allocation differed from Travelers’ clear understanding that the settlement “was not paid to eliminate Travelers’ exposure solely with respect to [one] site.”¹²² Yet, other cases involving settlement allocation to facultative reinsurers make clear that the allocation analysis before and after settlement need not be consistent — follow the settlements “extends to a cedent’s post-settlement allocation decisions, regardless of whether an inquiry would reveal an inconsistency. . . .”¹²³ Moreover, “[r]equiring post-settlement allocation to match pre-settlement analyses would permit a reinsurer, and require the courts, to intensely scrutinize the specific factual information informing settlement negotiations, and would undermine the certainty that the general application of the doctrine to settlement decisions creates.”¹²⁴

This court's analysis differs from the usual treatment of facultative certificates; however, the same finding could likely have been reached by analyzing whether the settlement allocation met the typical follow the settlement requirements of good faith, reasonableness, and coverage within the applicable policies.¹²⁵

Lessons From These Cases

A careful analysis based on either a facultative or treaty perspective is a good starting point for a reinsurance allocation issue.

Most recent cases involving a cedent's settlement allocation to a facultative certificate show that this allocation will be followed as long as it is reasonable, in good faith, and within the relevant policy.¹²⁶ Even in the cases that test coverage, good faith or reasonableness, the reinsurer's burden for a finding against the cedent is high. These cases also illustrate that it is in the cedent's interest not to document an allocation method during, or in, settlement. As seen in *Travelers v. Gerling* and *American v. Swiss Re*, the courts suggested that had the cedent explicitly articulated an allocation method in the settlement different from that used to bill reinsurers, the result may have been different. Finally, a reinsurer should make sure that its own hands are clean when beginning the inquiry into a cedent's good faith and reasonableness.¹²⁷

In the treaty context, the key in determining whether a reinsurer must follow a cedent's allocation decisions is a carefully constructed reinsurance treaty. Critical to the court's determination will be the definitions of "occurrence" or "disaster and/or casualty," and how these terms are interpreted. Different states, as well as the United Kingdom, interpret these terms distinctly. Therefore, analyzing choice of law at the outset is advisable to determine whether the cedent's allocation method is supported.

Endnotes

1. This author wishes to thank Ann H. MacDonald (J.D. candidate May 2008, Washington University in St. Louis, Missouri) for her substantial drafting assistance.

2. See *North River Ins. Co. v. ACE Am. Reinsurance Co.*, 361 F.3d 134 (2d Cir. 2004). Follow the fortunes generally refers to the reinsurer's duty to follow the insured's underwriting fortunes, whatever they may be. Follow the settlements applies this to a cedent's settlement agreement, requiring the reinsurer to abide by the cedent's fortunes in the settlement agreement. *Id.*
3. Eric S. Mattson & Sean M. Carney, *The Follow the Fortunes Doctrine in 2002: Evidence Experts and Allocation*, 13 Mealey's Litigation Report: Reinsurance, 24 (March 6, 2003) (providing background on follow the fortunes doctrine).
4. See Robert E. Sweeney, Jr., *Reinsurer's Perspective on Allocation* (May 9-10, 2002).
5. *Commercial Union Ins. Co. v. Seven Provinces*, 9 F.Supp.2d 49 (D.Mass. 1998), *aff'd on other grounds*, 217 F.3d 33 (1st Cir. 2000), *cert. denied* 531 U.S. 1146 (2001).
6. *Id.* at 68.
7. *Id.* at 67.
8. *Id.*
9. *Id.* at 68.
10. While some courts have noted that it would be possible for a facultative certificate to include language specific enough to preclude a follow the settlements application, most have found the language not to be a sufficiently clear limitation to the doctrine, *see infra*.
11. See *Travelers Cas. & Sur. Co. v. Gerling Global Reinsurance Corp. of Am.*, 419 F.3d 181 (2d Cir. 2005); and *Hartford Accident & Indem Co. v. ACE*, No. CV03017822S, 2005 WL 3663930 (Conn. Super. Ct. 2005).
12. *North River Ins. Co. v. ACE Am. Reinsurance Co.*, 361 F.3d 134 (2d Cir. 2004).
13. *Id.* at 141.
14. *Id.*

15. *Id.* at 138.
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.* at 140.
20. *Id.* at 140-141 (citing *North River*, 52 F.3d at 1206 (internal citations omitted)).
21. *Id.* at 141.
22. *Id.*
23. *Travelers Cas. & Sur. Co. v. Gerling Global Reinsurance Corp. of Am.*, 419 F.3d 181 (2d Cir. 2005).
24. *Id.* at 183.
25. *Id.*
26. *Id.* at 183-184.
27. *Id.* at 185.
28. *Id.* at 188.
29. *Id.* at 185; *see also id.* at 186, 188-189, and 193.
30. *Id.* at 190.
31. *Id.*; *see also Travelers Cas. & Sur. Co. v. Lloyd's*, 760 N.E.2d 319 (N.Y. 2001).
32. *Id.*
33. *Commercial Union Ins. Co. v. Swiss Reinsurance Am. Corp.*, 413 F.3d 121 (1st Cir. 2005).
34. *Am. Employers' Ins. Co. v. Swiss Reinsurance Am. Corp.*, 413 F.3d 129 (1st Cir. 2005).
35. *Commercial Union Ins. Co. v. Swiss Reinsurance Am. Corp.*, 413 F.3d 121, 121-122 (1st Cir. 2005).
36. *Id.* at 122-123.
37. *Id.* at 128.
38. Commercial Union applied its per-occurrence limit separately each year of its multi-year policies with Grace. *Id.* at 124.
39. *Id.* at 124.
40. *Id.* at 124.
41. *Id.* at 128.
42. *Id.* at 128 (emphasis in original).
43. *Id.*
44. *Id.*
45. *Am. Employers' Ins. Co. v. Swiss Reinsurance Am. Corp.*, 413 F.3d 129 (1st Cir. 2005).
46. *Id.* at 131-32.
47. *Id.* at 133-34.
48. *Id.* at 134.
49. *Id.*
50. *Id.*
51. *Id.* at 136.
52. *Id.*
53. *Id.* at 136, n. 8.
54. *Id.* at 137.
55. *Id.* at 139. The parties took the court's advice to settle in both *American* and *Commercial*, so there is no analysis of whether these matters met the good faith and reasonableness inquiries. *Commercial Union Ins. Co. v. Swiss Reinsurance Am. Corp.*, No. 1:00-cv-12267-DPW (D. Ma. Nov. 14, 2005); *Am. Employers' Ins. Co. v. Swiss Reinsurance Am. Corp.*, No. 1:00-cv-12266-JLT (D. Ma. Nov. 14, 2005).
56. *National Union Fire Ins. Co. v. Am. Reinsurance Co.*, 441 F.Supp.2d 646 (S.D.N.Y. 2006)); *see also Suter*

- v. General Accident Ins. Co.*, No. 01-2686, 2006 WL 2000881 (D.N.J. July 17, 2006), *vacated by Goldman v. General Accident Ins. Co.*, No. 201-CV-2686, 2007 WL 2781935 (D.N.J. May 24, 2007); and *Allstate Ins. Co. v. Am. Home Assurance Co.*, 837 N.Y.S.2d 138 (N.Y. App. Div. 2007).
57. *National Union*, 441 F.Supp.2d 646.
58. National Union provided coverage to the insured from 1988 to 1995, and only reinsured the 1994 year. *Id.* at 648-649. National Union settled with its insured and allocated claims to the 1994 year using a “manifestation” trigger, despite questioning whether that trigger was proper when used by the insured *Id.*
59. *Id.* at 651 (emphasis in original) (internal quotations and citations omitted).
60. *Id.* at 652.
61. *Id.*
62. *Id.* at 653 (internal quotations omitted).
63. *Id.* (citing *Travelers Cas.*, 419 F.3d at 193).
64. *Id.* at 653.
65. *Suter v. General Accident Ins. Co.*, No. 01-2686, 2006 WL 2000881, at *21 (D.N.J. July 17, 2006), *vacated by Goldman v. General Accident Ins. Co.*, No. 201-CV-02686, 2007 WL 2781935 (D.N.J. May 24, 2007). Integrity was declared insolvent in 1987 and Karen L. Suter, the Commissioner of Banking and Insurance of the State of New Jersey, was appointed as Liquidator of Integrity. *Suter*, 2006 WL 2000881, at *2. Stephen M. Goldman, the Commissioner of Banking and Insurance of the State of New Jersey, later became Liquidator of Integrity. *Goldman*, 2007 WL 2781935, at *1.
66. *Allstate Ins. Co. v. Am. Home Assurance Co.*, 837 N.Y.S.2d 138 (N.Y. App. Div. 2007).
67. *Goldman*, 2007 WL 2781935, at *1.
68. *Id.*
69. *Suter*, 2006 WL 2000881, at *21.
70. *Id.* at *3-4.
71. *Id.* at *1
72. *Id.* at *1.
73. *Id.* at *23 (internal quotation and citation omitted).
74. *See generally Id.* at *1-27.
75. *Id.* at *23-24 (emphasis in original).
76. *See generally Id.* at *1-27.
77. *Id.*
78. *Allstate Ins. Co. v. Am. Home Assurance Co.*, 837 N.Y.S.2d 138 (N.Y. App. Div. 2007).
79. *Id.* at 139.
80. *Id.* at 140-41.
81. *Id.* at 140.
82. *Id.*
83. *Id.* at 140-41.
84. *Id.* at 141.
85. *Id.*
86. *Id.* at 141-42.
87. *Id.* at 143.
88. *Id.* at 144 (emphasis in original) (citations omitted).
89. *Id.* at 144-45.
90. *Id.* at 143.
91. *Id.* at 145.
92. *Id.* at 146.

93. *Travelers Cas. & Sur. Co. v. Lloyd's*, 760 N.E.2d 319 (N.Y. 2001).
94. *Hartford Accident & Indem. Co. v. ACE*, No. CV03017822S, 2005 WL 3663930 (Conn. Super. Ct. 2005).
95. *Travelers v. Lloyd's*, 760 N.E.2d 323-325.
96. *Id.*
97. *Id.* at 323.
98. *Id.*
99. *Id.* at 324-25.
100. *Id.* at 325.
101. *Id.* at 326-27.
102. *Id.* at 326.
103. *Id.*
104. *Id.* at 327.
105. *Id.* at 328.
106. *Id.* (internal citation and quotations omitted).
107. *Id.* at 329.
108. *Hartford Accident & Indem. Co. v. ACE*, No. CV03017822S, 2005 WL 3663930 (Conn. Super. Ct. Dec. 14, 2005).
109. *Id.* at *1.
110. *Id.*
111. *Id.*
112. *Id.* at *4.
113. *Id.* at *7.
114. *Id.*
115. *Id.*
116. *Argonaut Ins. Co. et al. v. Travelers Ins. Co.*, No. 124063/2000, 2005 WL 66778, (N.Y. Sup. Ct. Jan. 5, 2005).
117. *Id.* at ***2.
118. *Id.*
119. Interestingly, Travelers was the cedent in both of these cases, perhaps prompting the court not to have inconsistent results regardless of whether the reinsurance was facultative or treaty. *Id.*; see also *Travelers v. Lloyd's*, 760 N.E.2d 328-329.
120. *Argonaut v. Travelers*, 2005 WL 66778, ***3-6.
121. *North River v. ACE*, 361 F.3d at 141.
122. *Argonaut v. Travelers*, 2005 WL 66778, ***5-6.
123. *Travelers v. Gerling*, 419 F.3d at 188.
124. *North River v. ACE*, 361 F.3d at 141.
125. *Id.* at ***6.
126. See also *Travelers Cas. & Sur. Co. v. ACE Am. Reinsurance Co.*, 392 F.Supp.2d 659 (S.D.N.Y. 2005) (Discussing the extent to which a facultative certificate incorporates the underlying policy, where there is limiting language in the certificate, but holding that, without considering any extrinsic evidence, the certificates do not clearly or explicitly limit coverage), *aff'd*, 201 Fed.Appx. 40, 41 (2d Cir. 2006).
127. See e.g., *Zurich Am. Ins. Co. v. ACE Am. Reinsurance Co.*, No. 05 Civ. 9170 RMB JCF, 2006 WL 3771090 (S.D.N.Y. Dec. 22, 2006) (allowing discovery into reinsurer's past behavior with regard to follow the settlements to determine reinsurer's understanding of its obligations). ■

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1018 West Ninth Avenue, 3rd Floor, King of Prussia Pa 19406, USA
Telephone: (610) 768-7800 1-800-MEALEYS (1-800-632-5397)
Fax: (610) 962-4991
Email: mealeyinfo@lexisnexis.com Web site: <http://www.lexisnexis.com/mealeys>
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