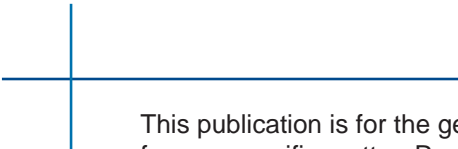


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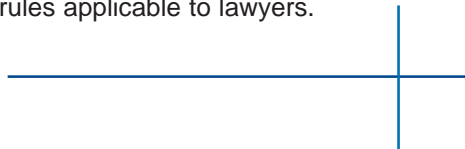


Developments:
American Reinsurance Disputes





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Dear Friends:

On a periodic basis, Schiff Hardin's Reinsurance and Insurer Insolvency Group distributes to our friends and clients articles on matters of current interest. We are happy to enclose for your review our latest offering.

Tony Burt has put aside his abiding passion for the Boston Red Sox long enough to prepare an article on a subject that is revolutionizing litigation in general and reinsurance litigation and arbitration in particular: electronic discovery. Tony explains how recent amendments and interpretations of the Federal Rules of Civil Procedure in the context of electronically stored information will almost certainly be applied in the arbitration arena, as will specific treatment of privilege, litigation hold procedures, early document preservation, and sanctions.

Everett Cygal, who is old enough to be more skeptical than he is about the Cub's prospects this season, addresses one of the most intellectually challenging issues in arbitration: the division of labor between the courts and arbitration panels over who gets to decide what, a matter Everett labels as "The Search for Clarity." His article surveys recent judicial pronouncements on the threshold issue of "arbitrability" and offers informed speculation on where the law is headed in this critical but highly confusing context.

Amy Rubenstein, who is far more passionate about reinsurance than baseball, has prepared an essential paper on the application of the "follow the settlements" concept to reinsurance allocation determinations. For those of you who believe this is a field so often plowed that nothing new or interesting is likely, please give this article ten minutes. It carefully examines much of the important case law in the area and demolishes a whole host of myths and fantasies. Like a friend once told me, its not what you don't know that hurts you, its what you know that ain't so.

We hope you will find this collection interesting and helpful and that you will join me in the fervent hope that the Chicago White Sox will rise once again.

Best wishes for a happy autumn season.

Sincerely,

David M. Spector

David M. Spector

Developments: American Reinsurance Disputes

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Electronic Discovery in Reinsurance Disputes

By Antony S. Burt

Nearly all business information today is created and maintained in electronic form, most of which is never even converted to paper. E-mails make up the substantial majority of all corporate communications. Many large companies routinely generate more than one million e-mails each day. This is particularly true in the insurance industry where companies have long maintained important business data in an electronic format.

With businesses increasingly relying on electronic information, it is not surprising that discovery in American litigation is increasingly focused on recovering electronically stored information ("ESI"). New federal discovery rules were recently implemented in order to keep pace with technological developments. The amended Federal Rules of Civil Procedure became effective December 1, 2006 and govern the discovery of ESI in federal court litigation. While some reinsurance disputes take place in federal court, the majority of reinsurance disputes are resolved through arbitration. The Federal Rules of Civil Procedure are not controlling in reinsurance arbitrations. Nevertheless it is anticipated that arbitration panels will increasingly look to the federal rules in deciding how to handle the production and use of ESI. Similarly, in discussions among counsel over how ESI discovery should be handled in the arbitration, many parties will demand that the discovery obligations will follow the applicable federal rules.

This paper is designed to provide the reader with a practical understanding of the e-discovery issues facing an insurance or reinsurance company engaged in or anticipating litigation or arbitration and to suggest some early steps to facilitate compliance with e-discovery requirements.

What Constitutes Electronically Stored Information

The federal rules include, without defining, the term "electronically stored information" in the enumerated list of what information must be produced in litigation. This term is intentionally undefined in the rules. Rather, the term ESI is intended to be construed broadly to cover any type of information that is stored electronically and to account for future technological changes. The most common example of ESI is an e-mail, but it is not limited to e-mails. ESI includes, among other things, databases, spreadsheets, back-up tapes, word processing documents, embedded information such as metadata, and information residing on portable storage devices such as BlackBerries. Metadata is information in ESI that is not seen on the computer screen such as how, when and by whom an electronic document was created, modified, and/or transmitted.¹

Production Of Electronically Stored Information

In responding to a document request submitted in a federal court lawsuit, a party must produce all relevant, non-privileged ESI. The party requesting ESI may designate the form in which the ESI shall be produced.² If the requesting party does not designate the form for production, the responding party must produce

¹ Federal courts have found metadata relevant and subject to discovery. *Celerity v. Ultra Clean Holding*, 2007 WL 632711 (N.D. Cal. Feb. 28, 2007) (Court held plaintiff entitled to receive metadata reflecting earlier drafts of opinion of defendant's counsel). See also, *Williams v. Sprint/United Management Co.*, 230 F.R.D. 640, 651 (D. Kan. 2005) ("When a party is ordered to produce electronic documents as they are maintained in the ordinary course of business, the producing party should produce the electronic documents with their metadata intact, unless that party timely objects to production of metadata, the parties agree that the metadata should not be produced, or the producing party requests a protective order.").

² Fed. R. Civ. P. 34(b).

the information either in a manner in which it is “ordinarily maintained” or in a form that is “reasonably usable.”³ A party may elect to produce the documents in their native form — *i.e.*, the way the information is ordinarily maintained. Generally, this is the least burdensome method. However, there are reasons why a party may not want to produce ESI in its native format, such as it is easy to alter the information produced in this manner and is cumbersome to use in depositions and hearings because it cannot be uniquely marked for identification. It is also difficult to remove or redact privileged or confidential information when produced in its native format.

A reasonably usable form could be producing Tagged Image File Format (“TIFF”) or Adobe Portable Document Format (“PDF”) images along with a database that maintains the hidden metadata. The benefit of this method is that the information cannot be modified and it is easier to review the information for privilege or confidentiality. However, converting all of the company’s relevant ESI to PDF or TIFF images may be prohibitively expensive, even if it is more usable in litigation.

If the requesting party specifies a particular form for producing ESI, the party producing the information may challenge the chosen form. However, the objecting party must state the basis for the objection and the form in which it intends to produce the ESI. If the parties cannot agree on an alternative form, a judge will need to decide which form is appropriate under the circumstances. It is worth noting that the federal rules provide that a party is only required to produce ESI in one form — even if it is stored in multiple forms.⁴

It is clear that a party can no longer make production of ESI by paper copy under the amended federal rules. If information is maintained in any electronically searchable form, a party cannot unilaterally decide to produce the documents in paper form. However, the parties may jointly agree to exchange ESI in paper form, such as e-mails instead of an electronically searchable form. The requesting party may also seek to inspect, test or sample ESI before requiring a complete production.

Importantly, the federal rules governing ESI are not limited to parties to the litigation. By subpoena, a non-party to the lawsuit may be compelled to produce ESI “in a form or forms in which the person ordinarily maintains it or in a form or forms that are reasonably useable.”⁵ The records of non-party insurance/reinsurance companies are frequently subpoenaed by litigants, and these provisions will likely increase the burden on complying with subpoenas.

Limitations on Discovery of Electronically Stored Information

Undue Burden

Despite this expansion in the production obligations in discovery, ESI production requests must still be relevant (*i.e.*, “reasonably calculated to lead to the discovery of admissible evidence”) and cannot require the production of privileged information.⁶ Moreover, the federal rules now state that relevant ESI information need not be produced where the burden is too great: “[a] party need not provide discovery of electronically stored information from sources that the party identifies as not reasonably accessible because of undue burden or cost.”⁷ Among the factors the court will consider in determining whether there is an undue burden are: i) the

³ Fed. R. Civ. P. 34(b)(ii).

⁴ Fed. R. Civ. P. 34(b)(iii).

⁵ Fed. R. Civ. P. 45(d)(1)(D).

⁶ Fed. R. Civ. P. 26.

⁷ Fed. R. Civ. P. 26(b)(2)(B).

specificity of the discovery requests; ii) whether the information can be obtained from more convenient sources; iii) whether party has previously deleted any relevant materials; iv) the likely relevance and importance of the information; v) the issues in the case; and vi) the relative resources of the parties.⁸ However, even if a court finds an undue burden, the requesting party may still seek production for “good cause.” If a court determines ESI is “not reasonably accessible,” it may require production while shifting the costs of production to the requesting party or imposing other conditions. Without court direction, a responding party typically bears its own costs of producing the requested ESI.

A recent reinsurance case addressed the some of the production issues involving ESI. In *Zurich American Ins. Co. v. ACE American Reinsurance Co.*,⁹ Zurich sought the production of documents related to two other lawsuits in which ACE was found to have wrongly denied payment to its cedents as well as all documents relating to any claims denied by ACE on the basis of allocation. ACE objected on the grounds of relevance and undue burden. The court found the requested information relevant and was unsympathetic to ACE’s undue burden argument. ACE had submitted an affidavit claiming that its computer system “is incapable of segregating claims by the amount of the claim, the type of claim, the identity of the cedent or the reason the claim may have been denied.”¹⁰ The court retorted that “[a] sophisticated reinsurer that operates a multimillion dollar business is entitled to little sympathy for utilizing an opaque data storage system, particularly when, by the nature of its business, it can reasonably anticipate frequent litigation.”¹¹ Nevertheless, recognizing the infeasibility of a broad search of ACE’s database, the court allowed the sampling protocol proposed by both parties. The court advised that any complaints about cost and burden required specific evidence from ACE. This case makes clear that the federal courts view insurance/reinsurance companies as sophisticated users of ESI and are unlikely to allow much latitude in producing ESI.¹²

Claw-Back of Privileged ESI

The new federal rules recognize the difficulty of reviewing voluminous ESI for privilege. Federal Rules of Civil Procedure Rule 26(b)(5) contains a new procedure for retrieving inadvertently produced privileged material that applies to all discovery, not just ESI. If a producing party subsequently determines that privileged information was produced, “the party making the claim may notify any party that received the information of the claim and of the basis for it.”¹³ The receiving party must either promptly return or destroy the claimed privileged information or present it to the court under seal for a determination of the claim of privilege.

This provision in the federal rules does not address whether the inadvertent production of privileged ESI will be deemed to be a waiver of the privilege in subsequent disputes. The parties may wish to enter into an agreement that the production of privileged ESI materials does not constitute a waiver and agreeing to permit a “claw-back” of inadvertently produced materials. There is case authority that if a claw-back agreement is made part of a court order, a party is protected from a

⁸ Fed. R. Civ. P. 26(b)(2) (2006 Advisory Committee Notes).

⁹ 2006 WL 3771090 (S.D.N.Y. December 22, 2006).

¹⁰ *Id.* at 2.

¹¹ *Id.*

¹² See also, *Miller v. Holzmann*, 2007 WL 172327 (D.D.C. Jan. 17, 2007) (federal government failed to issue litigation hold and its failure to do so was unreasonable and sanctionable). But see, *Ameriwood Industry v. Liberman*, 2006 WL 3825291 (E.D. Mo. Dec. 27, 2006), *am. on clarification*, 2007 WL 685623 (E.D. Mo. Feb. 23, 2007) (Court shifted cost of copying defendant’s hard drives and recovering deleted information to the requesting party. Court found information requested, while relevant, was not reasonably accessible because of undue burden of cost).

¹³ Fed. R. Civ. P. 26(b)(5)(B).

finding of waiver in a separate lawsuit.¹⁴

Early Action Required On ESI Preservation Obligations

A party cannot necessarily wait until the lawsuit or arbitration is underway to identify and secure ESI. The federal courts have found that an insurer/reinsurer has a duty to preserve relevant ESI when litigation is pending or threatened, or even if it reasonably anticipates it will be engaged in litigation.¹⁵ This duty extends beyond information maintained in the United States and arguably includes all information within the party's custody or control, including databases maintained by third parties. The receipt of a subpoena also triggers a duty to preserve on a third party.

Once a party reasonably anticipates litigation, it has an affirmative obligation to identify, locate and control potentially relevant ESI. Among the groups that should be contacted are the technology department, the underwriters, the claims handlers and the records department. It is critical that these groups are advised to suspend any destruction (scheduled or otherwise) of possibly relevant ESI.

However, a party is only required to make a reasonable and good faith effort to preserve ESI. The courts recognize that routine business processes to clear up space are a business necessity and difficult to interrupt. For example, the duty to preserve may not apply to backup tapes of ESI because such information is often rotated through normal processes. However, there are instances where back-up information is readily accessible and relevant, where these tapes may need to be preserved. It is advisable to seek an agreement with the other side on the issue of back-up information early in the proceeding. Similarly, courts recognize there are dynamic databases where the information is always changing without the specific direction or even awareness of the party. These types of routine alterations are generally accepted by courts so long as there is no hint of an intent to destroy relevant information.

The report of the Judicial Conference Advisory Committee with respect to the proposed amendments acknowledges the validity of the basic principal that all data has a natural life cycle:

The proposed rule recognizes that all electronic information systems are designed to recycle, overwrite, and change information in routine operation, not because of any relationship between the content of particular information and litigation, but because they are necessary functions of regular business operations ... Similarly, the regular purging of e-mails or other electronic communications is necessary to prevent a build-up of data that can overwhelm the most robust electronic information systems.¹⁶

The federal rules provide that a court may not impose sanctions on a party, “[a]bsent exceptional circumstances,” if the party “fail[ed] to provide electronically stored information lost as a result of a routine good-faith operation of an electronic information system.”¹⁷ This rule only provides a limited “safe harbor” and it is less likely to provide protection where the party lacks an established document retention policy. A party cannot simply take no action to preserve ESI and “exploit the routine operation of an information system to thwart discovery by allowing that operation to

¹⁴ *Hopson v. City of Baltimore*, 232 F.R.D. 228 (D. Md. 2005).

¹⁵ *Zubulake v. UBS Warburg, LLC*, 220 F.R.D. 212, 216 (S.D.N.Y. 2003).

¹⁶ Report of the Judicial Conference Committee on Rules of Practice and Procedure to the Chief Justice of the United States and the Members of the Judicial Conference of the United States, at 33-34 (2005).

¹⁷ Fed. R. Civ. P. 37(f).

continue in order to destroy specific stored information that it is required to preserve.”¹⁸

Litigation Hold

Once litigation is reasonably anticipated, a party should implement a “litigation hold.” A litigation hold is the process used to advise the necessary personnel to preserve ESI. ESI should be maintained in its native format so that embedded data can be produced if it is ultimately deemed relevant. Obviously, it may not be necessary to retain embedded data if parties have already affirmatively agreed not to produce such information.

A party must take certain actions to put the litigation hold in place. First, the party must identify the relevant time frame, possible data sources and the person(s) with possession of ESI as well as hard copy documents. In order to implement an effective litigation hold, counsel handling the dispute is obligated to develop an understanding of the client’s information systems. Counsel must “oversee compliance with the litigation hold, monitoring the party’s efforts to retain and produce the relevant documents.”¹⁹ Any processes that may automatically delete relevant information should be disabled, unless the burden or business interruption is too significant.

It is also necessary that there is monitoring of compliance with the litigation hold once it is implemented. The litigation hold should be re-issued so that new employees are aware of the preservation obligation and existing employees are reminded. The scope of the litigation hold should be dynamic and may need to be amended as the nature of the case expands, contracts or changes. Finally, a party should assume that its litigation hold process will be disclosed to opposing counsel during the litigation and actions should be taken accordingly.

Consequences of Failing to Preserve ESI

Spoliation of ESI after litigation commences or is reasonably foreseeable may result in sanctions.²⁰ Spoliation is defined as “the destruction or significant alteration of evidence, or the failure to preserve property for another’s use as evidence in pending or reasonably foreseeable litigation.”²¹ Sanctions are not limited to the intentional destruction of ESI; sanctions may result if a party is negligent in preserving ESI. A court has a wide range of sanctions that it may impose on the violating party, including monetary fines, adverse inference instructions, exclusion or limitation on use of evidence, professional sanctions against the lawyers, a directed verdict against the violating party on one or more issues, or even criminal punishment for obstruction of justice. An arbitration panel does not have the authority to impose all of these sanctions; rather the panel’s authority may be limited by the arbitration clause. However, in a typical arbitration, a panel has ample authority to impose meaningful sanctions for a failure to preserve discoverable information.

Two renowned cases resulting in draconian sanctions against the party violating the discovery rules involving industry giants — Morgan Stanley and Phillip Morris — are instructive. In *United States v. Phillip Morris*,²² the federal district court barred the trial testimony of eleven employees of Phillip Morris who had critical testimony for the defendant, and imposed a \$2.75 million sanction award. Phillip Morris’ sin was that it allowed e-mails over sixty days old to be deleted after the district court had entered an order requiring Phillip Morris to preserve ESI.

¹⁸ *Id.*, 2006 Advisory Committee Notes.

¹⁹ *Zubulake v. UBS Warburg*, at 431 (quoting *West v. Goodyear Tire & Rubber Co.*, 167 F.3d 776, 779 (2d Cir. 1999)).

²⁰ *Zubulake v. UBS Warburg*, 229 F.R.D. 422, 432 (S.D.N.Y. 2004).

²¹ Fed. R. Civ. P. 37.

²² 327 F. Supp. 2d 21, 25-26 (D.D.C. 2004).

Perhaps an even more well known case is *Coleman v. Morgan Stanley*.²³ After a long history of discovery disputes in the case, the state court learned that Morgan Stanley had failed to produce numerous data tapes and e-mails and had even overwritten certain e-mails in violation of federal law. The judge responded reversing plaintiff's burden of proof on the conspiracy counts and granting an adverse interference instruction due to Morgan Stanley's destruction of e-mails and non-compliance with the court's order. While state law may vary with respect to ESI discovery obligations and appropriate sanctions for discovery violations, it is likely that state courts will be influenced by the applicable federal rules.

At this early date, there are few rulings on appropriate sanctions for violating the new federal rules on ESI discovery. Nevertheless, it is virtually certain that courts will continue to impose a range of sanctions on parties who ignore their discovery obligations.

Conclusion

The creation and storage of business information in electronic forms has resulted in a seismic change in the way discovery is conducted in American litigation. The new Federal Rules of Civil Procedure attempt to recognize and adapt to that fundamental change. These rules place a greater immediate burden on the parties by requiring earlier and greater understanding of ESI sources and mandating affirmative steps to preserve such information.

The following steps should be considered, among others, even before litigation has commenced or is reasonably anticipated:

- Inside and regular outside counsel should become familiar with client's information systems and information management policies and what steps need to be taken to preserve relevant ESI even before litigation is reasonably foreseeable.
- Companies should review (or create if necessary) their document retention policies. The policies should focus on preservation rather than destruction of information and should provide for a method of preserving appropriate ESI in a litigation setting. The existence of a written policy that is enforced is evidence of a party's good faith intent to preserve relevant information.
- Companies should have a system in place to implement and continue a litigation hold on relevant information when litigation is reasonably foreseeable. The litigation hold should advise appropriate company personnel and departments (including IT and document retention personnel) of the existence of actual or potential litigation, along with an instruction to preserve all relevant information. Companies should seek to formalize the litigation hold procedure by including it in the company's document retention policy.

²³ 2005 WL 674885 (Fla. Cir. Ct. March 23, 2005). At trial, a jury awarded the plaintiff \$1.58 billion. Earlier this year, the Florida appellate court reversed on the basis that the plaintiff could not establish its entitlement to compensatory damages. The appellate court did not reach the issue of sanctions. 955 So. 2d 1124 (Fla. App. 4th Dist. March 21, 2007), *rehearing denied* (June 4, 2007).



Recent Supreme Court Decisions Regarding the Arbitrability Issue: The Search for Clarity

By Everett J. Cygal

In 1995, the Supreme Court in *First Options of Chicago, Inc. v. Kaplan*,¹ addressed who should have the primary responsibility — the court or the arbitrator — to decide issues of arbitrability, which the Court defined as a disagreement between the parties as to whether they agreed to arbitrate the merits of the dispute.²

In *First Options*, Kaplan, an options trader on the Philadelphia Stock Exchange (the “Exchange”), incurred a substantial trading deficit as a result of the 1987 market crash. After the crash, the Exchange, Kaplan and his company MKI entered into a workout that was embodied in four separate agreements. The agreement signed by MKI was the only agreement (out of the four) that contained an arbitration agreement. After a dispute arose regarding the workout, the Exchange demanded arbitration to recover against MKI and Kaplan. Kaplan denied that his disagreement with the Exchange was subject to arbitration. Nevertheless, Kaplan appeared before the arbitration panel to contest jurisdiction. The arbitrators concluded that they had the power to decide their own jurisdiction and, not surprisingly, they decided that they had the power to rule on the merits of the dispute with Kaplan.³

Because the Federal Arbitration Act⁴ (“FAA”) sets a high bar for overturning an arbitrator’s decision,⁵ the Supreme Court acknowledged that its decision on the question of who decides arbitrability (court or arbitrator) would “make a critical difference to a party resisting arbitration.”⁶

According to the Supreme Court, the answer to this “who decides” question was “fairly simple,” because it “turns upon what the parties agreed about *that* matter.”⁷ Relying on earlier precedent holding that “[c]ourts should not assume that the parties agreed to arbitrate arbitrability unless there is ‘clea[r] and unmistakabl[e]’ evidence that they did so,”⁸ the Court ruled in favor of Kaplan and explained its rationale as follows:

[G]iven the principle that a party can be forced to arbitrate only those issues it specifically has agreed to submit to arbitration, one can understand why courts might hesitate to interpret silence or ambiguity on the “who should decide arbitrability” point as giving the arbitrators that power, for doing so might too often force unwilling parties to arbitrate a matter they reasonably would have thought a judge, not an arbitrator, would decide.⁹

¹ 514 U.S. 938 (1995).

² *Id.* at 941.

³ *Id.*

⁴ 9 U.S.C. §1, *et seq.*

⁵ 9 U.S.C. §10

⁶ 514 U.S. at 943.

⁷ *Id.* (emphasis in original).

⁸ 514 U.S. at 944.

⁹ *Id.* at 945.

First Options, of course, is the easy case to resolve. While Kaplan may have been personally responsible for the debts of the company that he owned (MKI), he did not sign an arbitration agreement. Therefore, Kaplan *a fortiori* could not have intended to cede the “issue of arbitrability” to the panel because he never agreed to arbitrate in the first instance. In short, the Court’s holding states a truism as to the consensual nature of arbitrations that is “fairly simple” to apply in those rare cases where a party did not sign an arbitration agreement yet is being called upon to arbitrate a dispute.

Since *First Options*, lower courts have had to decide whether parties to otherwise valid arbitration agreements would have reasonably thought that a judge, not an arbitrator, would decide other fundamental issues: statute of limitations; class action arbitrations; consolidation; collateral estoppel and the like. The lower courts have also been left to balance two conflicting presumptions: “[c]ourts should not assume that the parties agreed to arbitrate arbitrability unless there is ‘clea[r] and unmistakabl[e]’ evidence that they did so,”¹⁰ versus the presumption that any doubts in construing contracting language “should be resolved in favor of arbitration.”¹¹

Moreover, the Supreme Court did not address how to apply this presumption in those cases where defenses such as fraud in the inducement were raised. In *Prima Paint v. Flood & Conklin Mfg. Co.*,¹² the Court announced the separability doctrine holding that challenges attacking the entire agreement’s validity rest with the arbitration panel, while challenges limited to the arbitration clause itself rest with the courts. If there was no agreement to anything in the first instance (due to fraud, illegality, unconscionability, etc.), however, a reasonable person could conclude that a question exists as to whether there was a binding agreement to arbitrate. Under *First Options*, it could be argued that the court, not the arbitrator decides that issue.

The difficulty applying this presumption is best exemplified in cases dealing with the National Association of Securities Dealers’ (“NASD”) six-year time-bar (*i.e.* contractual statute of limitations). Five Circuit Courts of Appeal (the Third, Sixth, Seventh, Tenth and Eleventh) concluded that this time limit was a substantive eligibility requirement that must be applied by the courts, while five other Circuits (First, Second, Fifth, Eighth and Ninth) concluded that the NASD time-bar was an issue for the panel.

Starting in 2002, a series of four Supreme Court decisions began to clarify the holding of *First Options*. In each case, the Court addressed the “who decides” question and, in each case, the Court concluded that it was for the arbitrators, not the courts, to decide those issues.

The first decision in this line of cases is *Howsam v. Dean Witter Reynolds, Inc.*,¹³ which resolved the above-mentioned Circuit split with respect to the NASD six-year time-bar. Not only did the Court resolve the Circuit split, the Court also significantly limited the presumption announced in *First Options*.

¹⁰ *First Options*, 514 U.S. at 944.

¹¹ *Moses H. Cone Memorial Hosp. v. Mercury Const. Corp.*, 460 U.S. 1, 25-26 (1983).

¹² 388 U.S. 395 (1967).

¹³ 537 U.S. 79 (2002).

The *Howsam* facts are straightforward. The arbitration agreement provided *Howsam* with a choice of arbitration forums. *Howsam* chose the NASD. *Howsam*, however, brought her claims after the expiration of the NASD six-year time bar. In the District Court, Dean Witter sought a declaration that the dispute was ineligible for arbitration because it was more than six years old. Dean Witter argued that this was for the court to decide per *First Options*. The Tenth Circuit Court of Appeals agreed.

The Supreme Court took a different view on the “who decides” question. The Supreme Court began its analysis reaffirming two principles from its prior jurisprudence: “arbitration is a matter of contract and a party cannot be required to submit to arbitration any dispute which he has not agreed to so arbitrate” and “the ‘question of arbitrability,’ is an issue for judicial determination [u]nless the parties clearly and unmistakably provide otherwise.”

After setting forth these principles, the Court went on to explain the limits of the presumed intent in favor of judicial determination. Specifically, the Court called this presumption an “interpretative rule” with limited scope. Acknowledging that the presumption, without limits, could require almost all disputes subject to arbitration to be decided in the courts, the Court stated, *inter alia*:

Linguistically speaking, one might call any potentially dispositive gateway question a “question of arbitrability,” for its answer will determine whether the underlying controversy will proceed to arbitration on the merits. The Court’s case law, however, makes clear that, for purposes of applying the interpretive rule, the phrase “question of arbitrability” has a far more limited scope. The Court has found the phrase applicable in the kind of narrow circumstance where contracting parties would likely have expected a court to have decided the gateway matter, where they are not likely to have thought that they had agreed that an arbitrator would do so, and, consequently, where reference of the gateway dispute to the court avoids the risk of forcing parties to arbitrate a matter that they may well not have agreed to arbitrate.¹⁴

Although the presumption that the contracting parties likely would not have agreed to let the panel decide arbitrability issues remains the cornerstone of this analysis, the Court identified two gateway categories of disputes for the courts to decide: (1) whether the arbitration contract binds parties who did not sign the agreement; and (2) whether an arbitration clause applies to a particular type of controversy covered.

The Court also divined that the parties likely would expect an arbitrator to decide procedural questions, which grow out of the dispute and bear upon its final disposition. These disputes, according to the Court, are presumptively not for the judge to decide.¹⁵ Accordingly, the Court ruled that the NASD time-bar was such

¹⁴537 U.S. 592 (citations omitted).

¹⁵The *Howsam* “procedural question” holding has been followed by the Circuit Courts with respect to the issue of arbitration consolidation. Prior to *Howsam*, the courts decided consolidation issues without assistance from arbitrators. See, *American Centennial Ins. Co. v. National Cas. Co.*, 951 F.2d 107 (6th Cir. 1991); *Protective Life Ins. Corp. v. Lincoln Nat’l Life Ins. Corp.*, 873 F.2d 281 (11th Cir. 1989); *Clarendon Nat’l Ins. Co. v. John Hancock Life Ins. Co.*, No. 00 Civ. 9222 (LMM), 2001 U.S. Dist. LEXIS 13736 (S.D.N.Y. 2001). After *Howsam*, the courts have been routinely referring the issue to the arbitrators to decide. See e.g., *Shaw’s Supermarkets, Inc. v. United Food and Commercial Workers Union*, 321 F.3d 251 (1st Cir. 2003); *Pedcor Management Co. v. Nations Personnel of Texas, Inc.*, 343 F.3d 355 (5th Cir. 2003); *Employers Ins. Co. of Wausau v. Century Indem. Co.*, 443 F.3d 573 (7th Cir. 2006); *Certain Underwriters at Lloyd’s v. Cravens Dargan*, No. 05-56154, 2006 U.S. App. LEXIS 20853 (9th Cir., Aug. 14, 2006); and *Markel Int’l Ins. Co. v. Westchester Fire Ins. Co.*, 442 F.Supp.2d 200 (D.N.J. 2006).

a procedural question that the parties intended to have the arbitrator decide: “NASD arbitrators, comparatively more expert about the meaning of their own rule, are comparatively better able to interpret and apply it . . . [therefore] it is reasonable to infer that the parties intended the agreement to reflect that understanding.”

The next year, the Supreme Court added a further gloss on its rationale in *PacifiCare Health Sys., Inc. v. Brook*.¹⁶ In *PacifiCare*, a group of doctors sued a number of health-care management organizations (“HMO”) alleging, among other things, that the HMOs violated the RICO statute. If successful under the RICO claim, the doctors would have been entitled to treble damages. The arbitration provisions in the various agreements contained non-identical provisions limiting punitive or exemplary damages.¹⁷

The HMOs sought to compel arbitration. The doctors resisted on the grounds that they could not obtain meaningful relief in arbitration for their RICO treble damages claim. The Supreme Court held that there was no question of arbitrability. Specifically, the Court concluded that the terms of the arbitration agreement were ambiguous creating uncertainty surrounding the parties’ intent with respect to the contractual term “punitive.”¹⁸ Assuming that the arbitration agreements were indeed as ambiguous as the Court stated, under *First Options*’ requirement of “clear and unmistakable evidence” that the parties intended for the arbitrators to decide this issue, the Court could have stopped its analysis there. Indeed, it is hard to imagine how this presumption could be overcome with an ambiguous arbitration agreement.

The Court, however, did not stop there. Rather, the Court went on to note that its own case law concerning statutory treble damages created a continuum on which certain statutory damages were punitive and others were compensatory.¹⁹ Because of all these ambiguities, the Court concluded that the application of the disputed language to the claims was “in doubt.”²⁰ Even though such a conflict could threaten the validity of the arbitration agreements, the Court, on ripeness grounds, decided to let the arbitrators decide the issue: “we should not, on the basis of ‘mere speculation’ that an arbitrator might interpret these ambiguous agreements in a manner that cast their enforceability to decide the antecedent question of how the ambiguity is to be resolved.”²¹ In other words, let the arbitrators have the first crack at deciding the issue with judicial review at some later date — presumably after a final award.

Later that same term, the Supreme Court, in a plurality opinion, decided *Green Tree Financial Corp v. Bazzle*.²² *Bazzle* applied the “who decides” question to class action arbitrations. The parties in *Bazzle* agreed to submit to the arbitrator “[a]ll disputes, claims or controversies arising from or relating to this contract or the relationships which result from this contract.”²³ The Supreme Court of South Carolina, applying South Carolina law, concluded that class action arbitrations were permitted when the arbitration clause was silent on the issue.²⁴ The

¹⁶538 U.S. 401 (2003).

¹⁷*Id.* at 404.

¹⁸*Id.* at 406-07.

¹⁹*PacifiCare*, 538 U.S. at 405-06

²⁰*Id.* at 407.

²¹*Id.*

²²539 U.S. 444 (2003).

²³*Id.* at 448.

²⁴*Bazzle*, 539 U.S. at 447.

Supreme Court, on the other hand, believed the issue was a matter of contract interpretation.

Because of the breadth of the arbitration agreement, the plurality concluded that the “parties seem to have agreed that an arbitrator, not a judge, would answer the relevant question.”²⁵ Citing *Howsam*, four Justices concluded that the question of whether the contract forbids class arbitration does not fall within the two narrow exceptions identified in *Howsam*. According to four Justices, the “relevant question” is what kind of arbitration proceeding did the parties agree to and, since that is a matter of contract interpretation: “[a]rbitrators are well situated to answer that question.”²⁶ Again, like the Court’s decision in *PacifiCare*, the Court has ignored its mandate in *First Options* of “clear and unmistakable evidence” that the parties intended to cede this issue to the panel. Indeed, “seem to have agreed” is a long way from clear and unmistakable evidence.

This holding did not garner five votes. Justice Stevens, who with his concurrence provided the fifth vote, believed that the South Carolina Supreme Court was correct when it held as a matter of state law that class-action arbitrations are permissible if the arbitration agreement is silent on the subject.²⁷ Justice Stevens, nevertheless, concurred in the judgment because, without his vote, “there would be no controlling judgment of the Court.”²⁸ The Circuit Courts are divided on the precedential effect of *Bazzle*.²⁹

Finally, in 2006, the Supreme Court in *Buckeye Check Cashing, Inc. v. Caregna*³⁰ clarified that *First Options* did not modify the separability holding of *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*³¹ In *Buckeye*, the Florida Supreme Court held that the plaintiff’s claim that the underlying contract was illegal and void *ab initio* had to be resolved by the trial court before arbitration of other disputes.³²

The Court identified two possible challenges with respect to the validity of arbitration agreements: challenges to the validity of the agreement to arbitrate versus challenges to the contract as a whole. As to these challenges the Court stated: “we addressed the question of who — court or arbitrator — decides these two types of challenges” in *Prima Paint*.³³ Reaffirming *Prima Paint* the Court held:

It is true, as respondents assert, that the *Prima Paint* rule permits a court to enforce an arbitration agreement in a contract that the arbitrator later finds to be void. But it is equally true that respondents’ approach permits a court to deny effect to an arbitration provision in a contract that the court later finds to be perfectly enforceable. *Prima Paint* resolved this conundrum — and resolved it in favor of the separate enforceability of arbitration

²⁵*Id.* at 451 (emphasis added).

²⁶*Id.* at 453.

²⁷*Id.* at 455 (Stevens, J. concurring).

²⁸*Id.*

²⁹*Compare Pedcor Management Co. Inc. Welfare Benefit Plan v. Nations Personnel of Texas, Inc.*, 343 F.3d 355, 358-59 (5th Cir. 2003)(holding that the validity of class arbitration is to be decided by the arbitrator, absent evidence that the parties intended the court to decide) with *Employers Ins. Of Wausau v. Century Indem.*, 443 F.3d 573, 580 (7th Cir. 2006)(“we cannot identify a single rationale endorsed by a majority of the Court”).

³⁰546 U.S. 440, 126 S.Ct. 1204 (2006)

³¹288 U.S. 395 (1967).

³²288 U.S. 395, ____, 126 S.Ct. at 1207.

³³*Id.* 126 S.Ct. at 1208.

provisions. We reaffirm today that, regardless of whether the challenge is brought in federal or state court, a challenge to the validity of the contract as a whole, and not specifically to the arbitration clause, must go to the arbitrator.³⁴

Without reference to *First Options* or the presumption that the parties likely expect courts, not arbitrators, decide issues of arbitrability, the Court reaffirmed its bright-line “who decides” test with respect to this issue. The logic of why *First Options* capacity claims are for the courts to decide versus *Prima Paint*’s fraud in the inducement claim are for the arbitrators to decide is not readily apparent. Presumably, a continuum of claims or defenses between *First Options* and *Prima Paint/Buckeye/Howsam* exists and where those claims or defenses fall, at this point, will be left to the lower courts.

With that said, and while it is always difficult to discern clear trends in Supreme Court jurisprudence, especially where, as here, one case was decided on ripeness issues and another was a plurality decision with questionable precedential value, it does seem that the Court has attempted to circumscribe the presumption that it so boldly announced in *First Options*. In each “who decides” opinion since *First Options*, the Court has not found a single instance where the matter was for the courts to decide. Perhaps the presumption of resolving all doubts in favor of arbitration has superseded the presumption of court involvement as set forth in *First Options*. While that may be one conclusion to reach from the recent Supreme Court jurisprudence, lower courts are still actively distinguishing these cases and deciding “arbitrability issues.”³⁵

Indeed, outside of the reaffirmation of *Prima Paint* in *Buckeye*, the state of the law remains unclear. As the Court rightfully acknowledged in *Howsam*, “any potentially dispositive gateway question” could be called a “question of arbitrability.” That said, however, the test provided in *Howsam* provides little additional guidance. It appears that courts will continue to decide these issues on an *ad hoc* basis upon the particular facts and what the court believes is fair under the circumstances. Perhaps that is the most that can be accomplished in any circumstance where a court is charged with the task of deciding what the parties likely intended when they entered into the arbitration agreement.

³⁴*Id.* 126 S.Ct. at 1210.

³⁵See e.g. *Kristian v. Comcast Corp.*, 446 F.3d 25 (1st. Cir. 2006)(questions of arbitrability to be decided by the court were raised by challenges to prohibition against treble damages, limitation on recovery of attorney fees and prohibition against class actions); *Nagrampa v. Mailcoups, Inc.*, 469 F.3d 1257 (9th Cir. 2006)(en banc)(validity of franchise agreement’s arbitration clause under California law was for the court and not the arbitrator to resolve); *Marie v. Allied Home Mort. Corp.* 402 F.3d 1(1st Cir. 2005)(allegation of waiver due to litigation conduct should be determined by a judge); *Tristar Fin. Ins. Agency, Inc. v. Equicredit Corp. of Am.*, 328 F.3d 462 (5th Cir. 2003)(same). But see *National Am. Ins. Co. v. Transamerica Occidental Life Ins. Co.*, 328 F.3d 462 (8th Cir. 2003)(issue of waiver is for the panel).



“Follow the Settlements” and Allocation: A Review of Recent Developments

By Amy M. Rubenstein¹

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

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).

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

⁶*Id.* at 68.

⁷*Id.* at 67.

⁸*Id.*

⁹*Id.* at 68.

¹⁰While 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).kr. C.D. Cal. 2005).

¹²*North River Ins. Co. v. ACE Am. Reinsurance Co.*, 361 F.3d. 134 (2d Cir. 2004).

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

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.

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.

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).

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

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.

³⁸Commercial 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.

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

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).

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

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); 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.

⁵⁸National 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).

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. In *Suter v. General Accident*, the District of New Jersey 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].”⁶⁷

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.⁶⁸ Integrity paid claims submitted by Pfizer, and then billed General Accident for a portion of those claims.⁶⁹ 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.⁷⁰

“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.”⁷¹ 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.⁷² 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.”⁷³ 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.⁷⁴ Therefore, the claims were not “even arguably within the terms of Integrity’s policy.”⁷⁵ *Suter* illustrates that a reinsurer can successfully challenge the cedent’s allocation, but the cedent’s conduct must be highly inappropriate.

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). Integrity was declared insolvent in 1987 and the New Jersey Commissioner of Insurance, Karen L. Suter, was appointed as Liquidator of Integrity. *Id.* at *2.

⁶⁶ *Allstate Ins. Co. v. Am. Home Assurance Co.*, 837 N.Y.S.2d 138 (N.Y. App. Div. 2007).

⁶⁷ *Suter*, 2006 WL 2000881, at *21.

⁶⁸ *Id.* at *3-4.

⁶⁹ *Id.* at *1.

⁷⁰ *Id.* at *1.

⁷¹ *Id.* at *23 (internal quotation and citation omitted).

⁷² See generally *Id.* at *1-27.

⁷³ *Id.* at *23-24 (emphasis in original).

⁷⁴ See generally *Id.* at *1-27.

⁷⁵ *Id.*

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

*Allstate v. American Home*⁷⁶ represents another successful challenge to a cedent's allocation. In *Allstate*, American Home provided commercial property insurance to United Technologies Corporation ("UTC").⁷⁷ UTC sued American Home in Connecticut District Court for indemnification from environmental pollution damage at sixteen different sites.⁷⁸ Both UTC and American Home maintained that each site involved multiple occurrences, but they disagreed as to how many occurrences per site.⁷⁹

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.⁸⁰ 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.⁸¹ 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.⁸²

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 reinsurers.⁸³ 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.⁸⁴ 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."⁸⁵

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

⁷⁶ *Allstate Ins. Co. v. Am. Home Assurance Co.*, 837 N.Y.S.2d 138 (N.Y. App. Div. 2007).

⁷⁷ *Id.* at 139.

⁷⁸ *Id.* at 140-41.

⁷⁹ *Id.* at 140.

⁸⁰ *Id.*

⁸¹ *Id.* at 140-41.

⁸² *Id.* at 141.

⁸³ *Id.*

⁸⁴ *Id.* at 141-42.

⁸⁵ *Id.* at 143.

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.⁸⁶

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."⁸⁷ 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.⁸⁸

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."⁸⁹ Notably, the court concluded that American Home's "inconsistent handling of loss is the very antithesis of the follow-the-fortunes doctrine."⁹⁰

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*⁹¹ and *Hartford v. ACE*.⁹² 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.⁹³ Travelers reinsured portions of these risks with various London reinsurers.⁹⁴ 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."⁹⁵ The treaties defined "each and every loss," "disaster and/or casualty," and included a follow the fortunes clause.⁹⁶ Travelers

⁸⁶ *Id.* at 144 (emphasis in original) (citations omitted).

⁸⁷ *Id.* at 144-45.

⁸⁸ *Id.* at 140-41.

⁸⁹ *Id.* at 145.

⁹⁰ *Id.* at 146.

⁹¹ *Travelers Cas. & Sur. Co. v. Lloyd's*, 760 N.E.2d 319 (N.Y. 2001).

⁹² *Hartford Accident & Indem. Co. v. ACE*, No. CV03017822S, 2005 WL 3663930 (Conn. Super. Ct. 2005).

⁹³ *Travelers v. Lloyd's*, 760 N.E.2d 323-325.

⁹⁴ *Id.*

⁹⁵ *Id.* at 323.

⁹⁶ *Id.*

settled a number of pollution claims with both companies, and treated each contamination site as a separate occurrence with respect to its insureds.⁹⁷ Then, Travelers billed the reinsurers by treating all 160 Koppers contamination sites as one loss and all 25 DuPont contamination sites as one loss.⁹⁸

The reinsurers rejected this allocation and argued that Travelers' aggregation of all the claims into one occurrence for each insured was contrary to the terms of the treaty reinsurance agreement.⁹⁹ 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.¹⁰⁰

In support of this theory, Travelers cited a British case requiring occurrence to have the broadest definition possible.¹⁰¹ 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.¹⁰²

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."¹⁰³ 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.¹⁰⁴

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 whenever it paid a claim, regardless of the contractual language defining loss.¹⁰⁵

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

⁹⁷ *Id.* at 324-25.

⁹⁸ *Id.* at 144 (emphasis in original) (citations omitted).

⁹⁹ *Id.* at 144-45.

¹⁰⁰ *Id.* at 140-41.

¹⁰¹ *Id.* at 145.

¹⁰² *Id.* at 146.

¹⁰³ *Travelers Cas. & Sur. Co. v. Lloyd's*, 760 N.E.2d 319 (N.Y. 2001).

¹⁰⁴ *Hartford Accident & Indem. Co. v. ACE*, No. CV03017822S, 2005 WL 3663930 (Conn. Super. Ct. 2005).

¹⁰⁵ *Travelers v. Lloyd's*, 760 N.E.2d 323-325.

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.¹⁰⁶ Hartford insured MacArthur Company, whose primary business was installing asbestos insulation.¹⁰⁷ Hartford, MacArthur and a number of other parties settled over 17,000 asbestos claims by an agreement to which Hartford contributed.¹⁰⁸ 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.”¹⁰⁹ 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.¹¹⁰ 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.”¹¹¹ 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.”¹¹² 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.¹¹³

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.¹¹⁴ Travelers insured Witco and paid it for environmental pollution claims.¹¹⁵ 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.¹¹⁶

¹⁰⁶ *Hartford Accident & Indem. Co v. ACE*, No. CV03017822S, 2005 WL 3663930 (Conn. Super. Ct. Dec. 14, 2005).

¹⁰⁷ *Id.* at *1.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Id.* at *4.

¹¹¹ *Id.* at *7.

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ *Argonaut Ins. Co. et al. v. Travelers Ins. Co.*, No. 124063/2000, 2005 WL 66778, (N.Y. Sup. Ct. Jan. 5, 2005).

¹¹⁵ *Id.* at ***2.

¹¹⁶ *Id.*

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,¹¹⁷ the court conducted an in-depth factual inquiry regarding the settlement allocation.¹¹⁸ 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."¹¹⁹ 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."¹²⁰ 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 ..."¹²¹ 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."¹²²

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.¹²³

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.¹²⁴ 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

¹¹⁷ 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.

¹¹⁸ *Argonaut v. Travelers*, 2005 WL 66778, ***3-6.

¹¹⁹ *North River v. ACE*, 361 F.3d at 141.

¹²⁰ *Argonaut v. Travelers*, 2005 WL 66778, ***5-6.

¹²¹ *Travelers v. Gerling*, 419 F.3d at 188.

¹²² *North River v. ACE*, 361 F.3d at 141.

¹²³ *Id.* at ***6.

¹²⁴ 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).

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.¹²⁵

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.

¹²⁵ 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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