Chapter 8

Reinsurer's Obligations to Cedent

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§ 8:1 Overview

Reinsurance is a vehicle for ceding companies to transfer underwriting risk to reinsurers. In exchange for premium payments to the reinsurer, the reinsurer is obligated to pay ceded losses pursuant to the reinsurance contract.

Reinsurance contracts often contain language requiring that disputes be resolved by arbitrators in accordance with the custom and practice of the insurance and reinsurance industry. Certain historical reinsurance contracts, particularly facultative certificates, may lack arbitration clauses and have therefore resolved their disputes through the courts.

While the outcome of reinsurance arbitrations are confidential, the decisions resulting from disputes that have been litigated do provide insight into how the obligations of reinsurers may be adjudged. This Chapter provides an overview and analysis of judicial precedent addressing certain obligations the reinsurer and the ceding company owe to each other, as well as implied rights and duties that insurers and reinsurers must navigate in the handling and scrutiny of claims prior to their formally being ceded for payment. In addition, emerging issues and newer reinsurance contract wording are discussed, as well as a summary of Practical Points gleaned from the case law presented.

§ 8:2 Introduction

What historically has been considered a "gentleman's agreement" has been the subject of a great deal of disagreement between ceding insurers and their reinsurers in recent years. Much of this controversy arose as a result of a significant number of asbestos, pollution and latent injury cessions, and has focused on the whether the duty of reinsurers to "follow the fortunes" or "follow the settlements" of ceding insurers binds them to pay cessions that arguably maximize the cedent's reinsurance recovery or that otherwise do not necessarily reflect the basis upon which the underlying coverage dispute was settled.

In this section we will consider certain rights and duties of reinsurers, both as regards the right to involve itself in the ceding insurer's handling of underlying claim and the scope of a reinsurer's duty to pay ceded losses. The section concludes with a discussion of whether reinsurer's duties extend to the reimbursement of declaratory judgment expenses.

§ 8:3 The reinsurer's right to associate or defend

While a reinsurer's duty to pay generally does not arise until the cedent actually pays a judgment or settlement, reinsurance agreements uniformly require the ceding insurer to give notice of claims that are "likely" to implicate the reinsurance or otherwise meet certain specified objective criteria.[1] Timely notice of serious claims affords the reinsurer the opportunity to exercise its rights under the agreement to associate or otherwise involve itself in the investigation, adjustment, defense or settlement of the underlying claim.

Reinsurance agreements contain various different clauses affording insurers these rights, including "right to associate," "claims cooperation" and "claims control" clauses.

A "right to associate" clause typically gives the reinsurer the right to participate "in the defense and control of any claim, suit or proceeding which may involve [the] reinsurance with the full cooperation of [the cedent]"[2] Association clauses permit the reinsurer to consult with and advise the reinsured in its handling of the claim without imposing any affirmative obligation on the reinsurer to investigate or pay for the defense of the underlying claim. While the level of association varies from relationship to relationship, the right generally includes more than the contractual right of inspection and claims review, and allows reinsurers the right to have and timely express an opinion about the ongoing handling of the underlying claim.

Some reinsurance agreements, particularly those emanating

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[1]See *British National Ins. Co. of Cayman v. Safety National Ins. Co.*, 335 F.3d 205 (3d Cir. 2003).

[2]*Unigard Security Ins. Co., Inc. v. North River Ins. Co.*, 4 F.3d 1049, 1055 (2d Cir. 1993).

from the London Market, contain "claims cooperation" which give reinsurers greater input and control over the defense than a conventional "right to associate" clause and which may explicitly require the reinsurer's consent before the insurer can settle.

Finally, some agreements contain "claims control" clauses that permit the reinsurer to participate directly in negotiations, adjustment and settlement of underlying claims. In general, these clauses are more common when the ceding company retains little or no risk and may therefore have little financial incentive to aggressively contest the insured's claim against it. These clauses cede the most control to a reinsurer and may impose an affirmative obligation on the reinsurer to exercise actual control over all or a portion of the claims handling, including the obligation to investigate, adjust and resolve claims.

The failure of the ceding insurer to give timely notice to its reinsurer may forfeit its rights to payment, although U.S. court differ with respect to whether the reinsurer must show prejudice in order to avoid coverage.[3]

In practice, reinsurers rarely avail themselves of the right to associate in the underlying defense, whether due to the added expense of association or concern that they may somehow expose themselves to extracontractual liability to the cedent or direct liability to the underlying claimant.[4]

§ 8:4 Scope of reinsurer's duty of good faith, generally

Just as the doctrine of *uberrima fides* requires the ceding insurer to be utterly candid in its disclosures to the reinsurer and in affording timely notice of a loss, so to is the reinsurer bound in good faith to pay losses that are ceded to it without second guessing the cedent's decision to settle. This duty—whether expressed as the reinsurer's duty to "follow the fortunes" or "follow the settlement" of the cedent—is not unbounded, however. In particular, a reinsurer may challenge a cession that was not made in good faith. Additionally, a reinsurer has no duty to pay losses that exceed the bounds of its contractual undertaking to the ceding insurer.

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[3] *North River Ins. Co. v. CIGNA Reinsurance Co.*, 52 F.3d 1194, 1216 (3d Cir. 1995) and *Unigard Security Ins. Co. v. North River Ins. Co.*, 4 F.3d 1049, 1068–70 (2d Cir. 1993).

[4] *Slotkin v. Citizens Cas. Co. of New York*, 614 F.2d 301, 316–17 (2d Cir. 1979), adhered to on rehearing, 614 F.2d 301, 323 (holding reinsurers directly liable to tort claimant in case where reinsurers controlled the defense and had full control over settlement).

As a federal judge in Massachusetts has found,[1] "[u]tmost good faith . . . requires a reinsurer to indemnify its cedent for losses that are even arguably within the scope of the coverage reinsured, and not to refuse to pay merely because there may be another reasonable interpretation of the parties' obligations under which the reinsurer could avoid payment."

The reinsurer's good faith duty to pay is a corollary of the ceding insurer's obligation to be utterly candid in the presentation of the claim. As the Second Circuit[2] has observed in examining the symbiotic relationship of these duties:

> Reinsurance involves contracts of indemnity, not liability. Reinsurers do not examine risks, receive notice of loss from the original insured, or investigate claims. In practice, the reinsurer has no contact with the insured . . . . The reinsurance relationship is often characterized as one of "utmost good faith." This utmost good faith may be viewed as a legal rule but also as a tradition honored by ceding insurers and reinsurers in their ongoing commercial relationships. Historically, the reinsurance market has relied on a practice of the exercise of utmost good faith to decrease monitoring costs and ex ante contracting costs . . . . [R]einsurers cannot duplicate the costly but necessary efforts of the primary insurer in evaluating risks and handling claims. Reinsurers may thus not have actuarial expertise . . . in defending ordinary claims. They are protected, however, by a large area of common interest with ceding insurers and by the tradition of utmost good faith.

§ 8:5 Scope of reinsurer's duty of good faith, generally—The "follow the settlements" doctrine

Many reinsurance agreements require the reinsurer to follow the ceding insurer's settlements. Such terms vary from contract to contract. Examples include:

> All loss settlements made by the Reinsured, including compromise settlements, shall be binding upon the reinsurer, providing that the loss underlying the settlement is within the terms of the original policy and is within the terms of the Reinsurance.
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> or:
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> All claims involving this reinsurance when settled by the Company, shall be binding on the Reinsurer, which shall be bound to pay its proportion of such settlements . . . .

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[1] *Commercial Union Ins. Co. v. Seven Provinces Ins. Co.*, 9 F. Supp. 2d 49, 69–70 (D. Mass. 1998), aff'd, 217 F.3d 33 (1st Cir. 2000). See also *United Fire & Cas. Co. v. Arkwright Mut. Ins. Co.*, 53 F. Supp. 2d 632, 642 (S.D.N.Y. 1999).

[2] Unigard Sec. Ins. Co. v. North River Ins. Co, 4. F.3d 1049, 1054 (2d Cir. 1993).

or:

> The liability of Reinsurer . . . shall follow that of Insurer, and except as otherwise specifically provided herein, shall be subject in all respects to the terms and conditions of Insurer's policy.

By contrast, London Standard Wording 343 provides:

> All loss settlements by the Reinsured including compromise settlements and the establishment of Funds for the settlement of losses shall be binding upon the Reinsurers, providing such settlements are within the terms and conditions of the original policies and/or contracts. . .and within the terms and conditions of this Contract.

U.S. courts have declared that "the 'follow the settlements' doctrine imposes on the reinsurer a contractual obligation to indemnify the reinsured or ceding company for payments the reinsured makes pursuant to a loss settlement under its own policy, provided that such settlement is not fraudulent, collusive or otherwise made in bad faith, or an *ex gratia* payment, such as one made to avoid the costs of litigation even though there is no legal obligation to pay."[1]

As a federal court in Illinois[2] explained:

> The purpose of follow-the-settlements clauses in reinsurance agreements is to bind a reinsurer to accept the cedent's good faith decisions on all things concerning the underlying insurance terms and claims against the underlying insured: coverage, tactics, lawsuits, compromise, resistance or capitulation. To allow the reinsurer to question the underlying settlement would be to relitigate the underlying claim all over again; there would be little incentive for the reinsured to settle its claims with policyholders. Therefore, once the reinsured enters into a settlement agreement with a policyholder, a follow-the-settlements provision requires the reinsurer to cover settlements made by the reinsured, as long as they are not fraudulent, collusive or made in bad faith.

Likewise, the British Court of Appeals ruled in *The Ins. Co. of Africa v. Scor (U.K.) R. Co. Ltd.*[3] that a reinsurer is bound to follow the settlement of and indemnify the ceding company so long as (1) the settled claim falls within the risks covered by the policy of reinsurance as a matter of law and (2) the ceding company

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[Section 8:5]

[1] *Aetna Cas. & Sur. Co. v. Home Ins. Co.*, 882 F.Supp. 1328, 1346 (S.D.N.Y. 1995), quoted in *North River Ins. Co. v. Employers Reinsurance Corp.*, 197 F. Supp. 2d 972, 986 (S.D. Ohio 2002).

[2] *Arrowood Indem. Co. v. Assurecare Corp.*, 2012 WL 4340699, *3 (N.D. Ill. 2012).

[3] *The Ins. Co. of Africa v. Scor (U.K.) R. Co. Ltd.*, 1 Lloyd's Rep. 312 (1985).

acted honestly and in a businesslike manner in making the settlement. As the *Scor* court explained:

> The original insurer of today might be the reinsurer of tomorrow; and trusting each other to act in the utmost good faith and saving the expense to reinsurers of disputing claims which the original insurers did not dispute, they agreed to insert in policies of reinsurance a clause applying their reinsurance to the original insurer's polices subject to the same terms and conditions and to pay as might be paid upon.

The *Scor* court further ruled that reinsurers could not avoid their duty to pay by showing, after the fact, that the underlying claim was not covered by the reinsured contracts of insurance. As Lord Justice Goff explained:

> If insurers have settled a claim, acting honestly and in a proper and businesslike manner, then the fact that reinsurers may thereafter be able to prove that the claim of the assured was fraudulent does not of itself entitle reinsurers not to follow the settlement of the insurers. In my judgment they must follow the settlement, as they have contracted to do.[4]

In the absence of a "follow the settlements" clause, the ceding insurer has a much greater burden of proof. At a minimum, it must establish that its settlement was covered by its policy and not an *ex gratia* payment.

Courts have generally declined to imply the existence of a "follow the settlements" requirement where one is not specifically set forth in the reinsurance contract notwithstanding cedents' arguments that the doctrine is implicit in industry practices.[5] As a federal court in Florida[6] declared, courts should not "go outside the laws of contract construction and outside the four corners of an unambiguous contract to add a clause that was not bargained for," even though there are "benefits and numerous public policy considerations supporting enforcement of the 'follow the fortunes' doctrine in the world of reinsurance."

◆ **Practice Point:** *Confirm that you have "follow the settle-*

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[4] *The Ins. Co. of Africa v. Scor (U.K.) R. Co. Ltd.*, 1 Lloyd's Rep. 312, 321–22 (1985).

[5] See *Employers Reinsurance Corp.*, 197 F. Supp. 2d 972, 986 (S.D. Ohio 2002) (applying New Jersey law) and *Affiliated FM Ins. Co. v. Employers Reinsurance Corp.*, 369 F. Supp. 2d 217, 227 (D.R.I. 2005). But see *Aetna Cas. & Sur. Co. v. Home Ins. Co.*, 882 F. Supp. 1328, 1349 (S.D.N.Y. 1995) and *International Surplus Lines Ins. Co. v. Certain Underwriters at Lloyd's, London*, 868 F. Supp. 917, 920 (S.D. Ohio 1994).

[6] Employers Reinsurance Corp. v. Laurier Indemnity Co., No. 03-1650 (M.D. Fla. 2006).

ments" or "follow the fortunes" language in your agreements. Are you in a jurisdiction where courts will imply a difference?

U.S. courts have tended to use the terms "follow the settlements" and "follow the fortunes" interchangeably to the point where any distinction between these doctrines has been blurred to the point of near extinction. Some courts have valiantly sought to maintain a distinction, however, explaining that "[t]he 'follow the fortunes' doctrine requires reinsurers to accept a reinsured's good faith decision that a particular loss is covered by the terms of the underlying policy, while the 'follow the settlements' doctrine requires reinsurers to abide by a reinsured's good faith decision to settle, rather than litigate, claims on that policy."[7] Likewise, a federal court in Ohio declared in North River Ins. Co. v. Employers Re,[8] that "the term 'follow the fortunes' more accurately describes the reinsurer's obligation to follow the reinsured's underwriting fortunes, whereas 'follow the settlements' refers to the duty to follow the actions of the reinsured in adjusting and settling claims."

Despite this semantic confusion, it is not apparent that the comingling of these doctrines has any practical impact on the outcome of reinsurance disputes, as U.S. courts treat the insurer's duty to "follow the fortunes" as implying a broader duty that certainly encompasses the duty to "follow the settlements." The same may not be true of courts in other countries, however.

§ 8:6 Scope of reinsurer's duty of good faith, generally—The "follow the fortunes" doctrine

"Under the "follow the fortunes" doctrine, a reinsurer is required to indemnify the reinsured for payments reasonably within the terms of the original policy, even if technically not covered by it. A reinsurer cannot second guess the good faith liability determinations made by its reinsured . . ."[1] As a result, the doctrine "requires payment where the cedent's good-faith payments to its insured is at least arguably within the scope of the insurance coverage that was reinsured."[2]

The "follow the fortunes" doctrine "binds a reinsurer to accept

[7] *Commercial Union Ins. Co. v. Seven Provinces Ins. Co., Ltd.*, 9 F. Supp. 2d 49, 66 (D. Mass. 1998).

[8] *North River Ins. Co. v. Employers Re*, 197 F.Supp. 2d 972, 978 (S.D. Ohio).

[Section 8:6]

[1] *Christiana General Ins. Corp. v. Great American Ins. Co.*, 979 F.2d 268, 280 (2d Cir. 1992).

[2] *Mentor Ins. Co. (UK) v. Brannkasse*, 996 F.2d 506, 517 (2d Cir. 1993).

the cedent's good faith decisions on all things concerning the underlying insurance terms and claims against the underlying insured: coverage, tactics, lawsuits, compromise, resistance or capitulation."[3] It insulates the cedent from a reinsurer's challenge unless the cession is fraudulent, in bad faith, or the payments are "clearly beyond the scope of the original policy" or "in excess of [the reinsurer's] agreed-to exposure."[4] "Basically, the doctrine burdens the reinsurer with those risks which the direct insurer bears under the direct insurer's policy covering the original insured."[5] It is well-established that a follow-the-fortunes doctrine applies to all outcomes, including settlements and judgments.[6]

As the New York Court of Appeals declared in *Travelers Cas. & Sur. Co. v. Certain Underwriters at Lloyd's of London*,[7] the doctrine "streamlines the reimbursement process and reduces litigation by preventing a reinsurer from continually challenging the propriety of a reinsured's settlement decisions."

§ 8:7 Limitations to the "follow the fortunes" doctrine, generally

Reinsurers are not obliged to accept or pay settlements that are presented in bad faith or that are contrary to the terms of their contracts of reinsurance with the ceding insurer.

§ 8:8 Limitations to the "follow the fortunes" doctrine, generally—Bad faith on the part of the cedent

A reinsurer seeking to avoid payment on the basis of a ceding insurer's claimed bad faith must show that the cedent acted with "deliberate deception, gross negligence, recklessness."[1] If there is a good faith dispute with respect to the ceding insurer's duties to

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[3] *British International Ins. Co. v. Seguros La Republica, S.A.*, 342 F.3d 78, 85 (2d Cir. 2003).

[4] *Christiana General Ins. Co. v. Great American Ins. Co.*, 979 F.2d 268, 280 (2d Cir. 1992).

[5] *Bellefonte Reins. Co. v. Aetna Cas. & Sur. Co.*, 903 F.2d 910, 912 (2d Cir. 1990).

[6] See *North. River Ins. Co. v. CIGNA Reinsurance Co.*, 52 F.3d 1194, 1205 (3d Cir. 1995) ("Thus, we find the clause applies both to settlements and to judgments").

[7] *Travelers Cas. & Sur. Co. v. Certain Underwriters at Lloyd's of London*, 96 N.Y.2d 583, 596 (2001).

[Section 8:8]

[1] *American Bankers Ins. Co. of Fla. v. Northwestern National Ins. Co.*, 198

its policyholder, its decision to settle is unlikely to be found to meet this standard.[2]

In one recent case, a reinsurer argued that it was bad faith for the ceding insurer to include claims within its cession that it had never investigated. At issue in *American Employers Ins. Co. v. Swiss Reins. America Corp.*,[3] was the insurer's settlement of an underlying coverage action involving 92 different hazardous waste sites. Of the 92 sites, 37 were deemed to be significant and ten were the real focus of the insurer's concern in its settlement discussions. At the time of its settlement with the insured for $44 million, American Employers had only obtained site specific cost estimates for the ten most important sites. Nevertheless, in ceding $20.1 million of the loss to Swiss Re pursuant to various facultative certificates, it included $1.2 million for the other twenty-seven sites. Swiss Re argued (and a Massachusetts District Court agreed) that as American Employers had no information about these sites and therefore could not assign any value to them in good faith.

On appeal, however, the First Circuit reversed the lower court's finding that American Employers' allocation of any amount of the settlement to sites that it had not investigated was bad faith. The court found the ceding insurer's use of an 80% discount for these 27 subsidiary sites was an extrapolation from earlier demands that the insured had made. Although somewhat arbitrary, the court took note of the cost and burden that would otherwise have been imposed on American Employers to develop more detailed site specific cost information for sites that were, in the final analysis, "small potatoes." The court therefore refused to apply a fixed rule for the amount of inquiry necessary to justify a settlement as "reasonable," declaring that "[h]ow far one looks, with what tools, and with what costs in money and delay, obviously depend on circumstances."

Whereas, a few courts have ruled, however, that a reinsurer is

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F.3d 1332, 1335-36 (11th Cir. 1999), quoting *Unigard Security Ins. Co., Inc. v. North River Ins. Co.*, 4 F.3d 1049, 1069 (2d Cir. 1993). See also *North. River Ins. Co. v. CIGNA Reinsurance Co.*, 52 F.3d 1194, 1216 (3d Cir. 1995) ("As we have noted, bad faith requires an extraordinary showing of a disingenuous or dishonest failure to carry out a contract. The standard is not mere negligence, but gross negligence or recklessness.").

[2]American Bankers, 198 F.3d at 1136–37 ("Under the state of the law at the time of the submission of Hartford's claim for payment, we cannot say that American Bankers acted in a grossly negligent or reckless manner in accepting or paying those claims.").

[3]*American Employers Ins. Co. v. Swiss Reins. America Corp.*, 413 F.3d 129 (1st Cir. 2005).

not bound to follow the insurer's settlement if the settlement was not even "arguably" covered by the underlying insurance policies,[4] the First Circuit's analysis in *American Employers* reflects a relatively pragmatic view of the reinsurance relationship and does not permit a reinsurer to impose unreasonably strict burdens of inquiry on aspects of the underlying claim that are relatively unimportant.

◆ **Practice Point for Reinsurers:** *Courts are unlikely to look kindly on after the fact arguments by reinsurers that cedent should have defended a clam differently. Such arguments may have greater force and effect if the reinsurer has exercised its right to associate and made these recommendations to the cedent at the time. Alternatively, a reinsurer should be prepared to be very specific in its argument to the court, demonstrating exactly what the cost of the additional work would have been, why it was commercially reasonable to assume that most insurers would have done this and what impact it had on the outcome of the claim.*

§ 8:9 Limitations to the "follow the fortunes" doctrine, generally—Bad faith on the part of the reinsurer

In a handful of cases, cedents have succeeded in obtaining bad faith awards against reinsurers for egregious claims investigation and baseless delays in making payment. Of these, the best known is *Commercial Union Ins. Co. v. Seven Provinces Ins. Co.*[1]

Commercial Union sought reinsurance from Seven Provinces for sums it had paid to settle various underlying environmental liability claims presented by Teledyne. Seven Provinces disputed the cession, arguing that Commercial Union had improperly allocated the loss to its facultative certificate. Further, Seven Provinces argued that Commercial Union never should have paid the loss since the claim in question involved an owned facility and was subject to the "owned property" exclusion in the underlying insurance policy reinsured by Seven Provinces.

Judge Gertner rejected these challenges, finding that the Com-

[4]See *Suter v. General Accident Ins. Co. of America*, 2006 U.S. Dist. LEXIS 48209 (D.N.J. 2006) (no duty where cedent failed to conduct a reasonable, businesslike investigation before settling). See also *American Marine Ins. Group v. Neptunia Ins. Co.*, 775 F. Supp. 703, 709 (S.D.N.Y. 1991), aff'd, 961 F.2d 372 (2d Cir. 1992) (requiring cedent to be "honest and businesslike" in adjusting the underlying claim).

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[1]*Commercial Union Ins. Co. v. Seven Provinces Ins. Co.*, 9 F. Supp. 2d 49 (D. Mass. 1998), aff'd 217 F.3d 33 (1st Cir. 2000).

mercial Union settlement was reasonable and that its cession was consistent with the manner in which it had settled the underlying environmental claims. Further, the court went on to award bad faith damages against the reinsurer, finding that Seven Provinces engaged in a "moving target" strategy of evasion and delay by making "numerous and constantly shifting requests for information and raising new defenses to payment." The court found that "Seven Provinces' intent in its dealings with Commercial Union was to delay and object to payment so that CU would compromise the Teledyne bill and agree to a global commutation of all of the business between the parties."

These findings were affirmed on appeal to the U.S. Court of Appeals for the First Circuit. As with Judge Gertner, the Court of Appeals declared that "Seven Provinces' conduct—raising multiple, shifting defenses, (many of them insubstantial) in a lengthy patter of foot dragging and stringing Commercial Union along, with the intent (as its own witness admitted) of pressuring Commercial Union to compromise it's claim had the extortionate quality that marks a 93A violation." Moreover, in light of the exacting standard of good faith required by the doctrine of *uberrima fides,* the First Circuit found that Seven Provinces' "bad faith tactics were wholly alien to the usual course of dealings between an insurer and a reinsurer, and thus were even more clearly removed from an ordinary breach of contract."

◆ **Practice Point:** *All of these disputes ultimately turn on the contents of the insurer or reinsurer's claim file and often concern privileged communications from in-house or outside coverage counsel. Although discovery rules differ from state to state, courts are generally relatively liberal in allowing discovery of privileged communications in bad faith cases, especially if the party seeking discovery has made a prima facie showing that the communications were in aid of the bad faith.*

§ 8:10 Limitations to the "follow the fortunes" doctrine, generally—Settlements inconsistent with terms of reinsurance agreement

A reinsurer is not bound to follow an insurer's fortunes insofar as the terms of the settlement are in conflict with the terms of the reinsurance contract.

Thus, the New York Court of Appeals ruled in *Travelers Cas. and Sur. Co. v. Certain Underwriters at Lloyd's of London*[1] that Travelers could not compel Lloyd's to reimburse it on a "single occurrence" basis where the treaties in question covered a "disaster and/or casualty," which was defined as "resulting from a series of accidents, occurrences and/or causative incidents." The court found that the "follow the fortunes" doctrine did not trump explicit contrary language in the contract of reinsurance.

The First Circuit ruled in *Commercial Union Ins. Co. v. Swiss Reinsurance America Corp.*[2] that a District Court erred in declaring that a reinsurer was not bound to follow the limits of coverage set forth in the ceded policy. The court ruled that Swiss Re was bound to follow the "annualized" limits approach upon which CU had settled the underlying pollution claims with its policyholder (W.R. Grace). Whether or not CU's coverage counsel was correct in predicting that New York would require that the policy limit apply once for each year and not once per policy, the court found that this view was binding upon Swiss Re under its follow the fortunes clause so long as the resulting settlement was reasonable and made in good faith. Since the reinsurance certificates did not expressly preclude annualization, the court declared that, "concurrency between the policy of reinsurance and the reinsured policy is presumed."

In *Arrowood Surplus Lines Ins. Co. v. Westport Ins. Co.*,[3] the Second Circuit affirmed a Connecticut court's ruling that a reinsurer had no obligation to reimburse the ceding insurer for losses paid on account of damages suffered after the reinsurance agreement ceased to be in effect. Despite Arrowood's argument that it settled due to the risk that a lower court might rule that it had issued a three-year policy rather than the one-year policy that it claimed to have issued, the court declared that the "follow the fortunes" doctrine had no application since losses occurring after 2000 were by definition beyond the time period of the policies that the reinsurance protected.

◆ **Practice Point:** *Insofar as a loss is ceded on a basis that is alien to the scope of the reinsurance agreement, it is important*

[Section 8:10]

[1] *Travelers Cas. and Sur. Co. v. Certain Underwriters at Lloyd's of London*, 760 N.E.2d 319, 327–29 (N.Y. 2001).

[2] *Commercial Union Ins. Co. v. Swiss Reinsurance America Corp.*, 413 F.3d 121 (1st Cir. 2005).

[3] Arrowood Surplus Lines Ins. Co. v. Westport Ins. Co., No. 08-1393 (D. Conn. Jan. 5, 2010), aff'd, 2010 WL 3933561 (2d Cir. Oct. 8, 2010).

that the reinsurer immediately bring this inconsistency to the attention of the ceding insurer.

§ 8:11 Application of the "follow the fortunes" doctrine, generally

The wave of large asbestos and environmental liability claims that inundated the U.S. casualty insurers in the 1990s has generated an unprecedented number of law suits between insurers seeking reimbursement for the settlement of those claims and reinsurers disputing their obligation to do so. Most of these cases turn on the issue of whether the settlements were unreasonably manipulated, before or after the fact, to reach the reinsurance.

In the next two subsections, we will discuss the following cases in which courts considered arguments by reinsurers that they had no duty to reimburse cedents for settlements that were demonstrably unreasonable or that reflected an allocation to reinsured years or layers based on legal theories that were at odds with positions that cedents took in the underlying disputes with their policyholders.

Case	**Claim Type**	**Issue**	**Prevailing Party**	**Holding**
Travelers Cas. v. Gerling Global Re, 419 F.3d 181 (2d Cir. 2005)	Asbestos	Post-settlement allocation	Cedent	Cedent's proposed allocation deserves deference even if not a part of underlying settlement; cedent not required to allocate so to minimize its reinsurance recovery.
Allstate v. American Home Assur. Co., 837 N.Y.2d 138 (App Div. 2007)	Pollution	Post-settlement allocation	Reinsurer	Post-settlement analysis prepared by outside counsel could not justify position on number of "occurrences" that was the opposite of what insurer had successfully disputed against insured in original DJ.

Case	**Claim Type**	**Issue**	**Prevailing Party**	**Holding**
American Employers Ins. Co. v. Swiss Re, 413 F. 3d 129 (1st Cir. 2005)	Pollution	Post-settlement allocation	Cedent	Cedent allowed to adopt allocation position on "annualization" of multi-year limits, even though insured never pursued it, because insured might *potentially* have sought recovery on this basis.
American Home Assur. Co. v. Everest Re, 653 A.2d 305 (Del. Super. 1994).	Pollution	Reasonableness	Reinsurer	Settlement that ignored Delaware law upholding pollution exclusion was legally unsupportable.
Hartford Acc. & Ind. Co. v. ACE American, 936 A.2d 224 (Conn. 2007)	Asbestos	Reasonableness	Cedent	Summary judgment should not have been granted to reinsurers where "common cause" language was ambiguous as to ability to aggregate underlying claims.
Hartford Acc. v. Columbia Cas. Co., 98 F. Supp. 2d 251 (D. Conn. 2000)	Pollution	Post-settlement allocation	Reinsurer	Summary judgment defeated based on evidence that cedent engaged in "self-serving" and unreasonable allocation.
North River v. ACE American, 361 F.3d 134 (2d Cir. 2004)	Breast implants	Post-settlement allocation	Cedent	Cedent held free to choose allocation theory that increases its reinsurance recovery so long as theory can be justified independent of reinsurance considerations.

Case	Claim Type	Issue	Prevailing Party	Holding
USF&G v. American Reins., 20 N.Y.3d 407 (2013)	Asbestos	Post-settlement allocation	Reinsurer	Summary judgment reversed based on finding that cedent should have included some component for release of serious bad faith claims and had inflated value of non-meso claims to enlarge recovery.
Utica Mutual Insurance Company v. Clearwater Insurance Company, 2016 WL 254770 (N.D. N.Y. 2016).	Asbestos	Post-settlement allocation	Reinsurer	No evidence that the cedent's settlement decision was unduly influenced by reinsurance considerations.

§ 8:12 Application of the "follow the fortunes" doctrine, generally—Disputes involving allocation decisions

Just as a growing number of recent reinsurance disputes have arisen out of the large losses that liability insurers have been obliged to pay to resolve asbestos and environmental liability claims, so too have these reinsurance cases often turned on issues involving allocation concerns with respect to how the ceding insurer settled the underlying cases. The issue in these cases typically turns on whether the ceding insurer is ceding its reinsurance claim on the same basis as it settled the underlying claim or whether, as is sometimes the case, the ceding insurer adopts a different theory of allocation post-settlement in order to maximize its reinsurance recovery.

In *Travelers Cas. & Sur. Co. v. Gerling Global Reinsurance Corp. of America*,[1] the Second Circuit declared that "a cedent's post-settlement allocation must be deferred to under a follow-the fortunes clause, regardless of any pre-settlement position taken

[Section 8:12]

[1] *Travelers Cas. & Sur. Co. v. Gerling Global Reinsurance Corp. of America*, 419 F.3d 181, 188 (2d Cir. 2005).

by the cedent, whether that position is articulated in a pre-settlement risk analysis or is implicit in the settlement with the underlying insured." The court explained that a reinsurer seeking to avoid application of follow the fortunes must make an "extraordinary showing of a disingenuous or dishonest failure" and 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."

A similarly deferential view to the cedent was adopted by the First Circuit in *American Employers Ins. Co. v. Swiss Reins. American Corp.*[2] Having settled with the insured for $44 million, American Employers ceded $20.1 million of the loss to Swiss Re, which had issued facultative certificates reinsuring three 3-year umbrella policies that had been in effect from 1962 to 1971. A key concern of American Employers in the pollution coverage litigation had been whether the "per occurrence" limits of those policies would be triggered on a "per policy" or "per year" (annualized) basis. Although American Employers had argued against annualization in its discussions with the insured and no mention was made of its in the final settlement agreement, American Employers adopted an "annualization" approach in its cession to Swiss Re.

Swiss Re resisted American Employers' billing on the ground that a non-annualized approach should be used that would have reduced the cession by $3.5 million. Swiss Re also contended that it should not have pay the $1.2 million allocated to the 27 secondary sites because American Employers had no information about these sites and therefore could not assign any value to them in good faith. A federal district court in Massachusetts agreed and granted summary judgment to Swiss Re on both claims.[3] On appeal, however, the First Circuit took a more nuanced view of the settlement. Even though the underlying insured had never really pursued the issue of "annualization" in the coverage litigation or its settlement negotiations with American Employers, the court pointed out that the insured *could* have raised such a claim at trial and, more importantly, American Employers had premised its own settlement analysis based on the likelihood that the insured would do so. The court found, therefore, that although the issue was "close," the ceding insurer's position was

[2] *American Employers Ins. Co. v. Swiss Reins. American Corp.*, 413 F.3d 129 (1st Cir. 2005).

[3] *American Employers Ins. Co. v. Swiss Reins. American Corp.*, 275 F. Supp. 2d 29 (D. Mass. 2003).

"supportable." The First Circuit emphasized that American Employers' "annualization" position was "not a post-hoc characterization or a unilateral post-settlement allocation without grounding in the settlement process itself" and observed that "t]here is considerable advantage in taking the insurer's own contemporaneous calculus as a starting point and then letting the objections be tested primarily under the rubric of reasonableness and good faith."

In addressing these issues, courts have declined to distinguish between pre- and post-settlement allocation decisions. As a Connecticut court[4] declared: "Applying the follow-the-settlements doctrine to post-settlement allocation decisions does not leave a reinsurer without protection. Cedents must make good-faith allocations, and reinsurers also cannot be held accountable for any loss not covered by the reinsurance policy.

Thus, in *North River Ins. Co. v. ACE American Reinsurance Co.*,[5] the Second Circuit held that "the 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 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." The court found that:

> Though pre-settlement analysis informs an insurer, such as North River, about the risks it faces, the range of risk, and the likelihood of a particular risk, that risk of loss is not "loss" under either the initial policy of insurance or the reinsurance contract. This risk of loss upstream is the very rationale for insurance; it is presumably why the direct insured first obtained insurance, and why the reinsured sought to cede coverage to the reinsurer. Risk of loss pervades insurance calculations and decisions, but insurers and reinsurers like ACE obligate themselves to pay only for loss incurred.

As a result, the Second Circuit declared that a ceding insurer "may engage in all manner of analyses to inform its decision as to whether, and at what amount, to settle, but those analyses are irrelevant to the contractual obligation of the reinsurer to indemnify the reinsured for loss under the reinsurance policy."

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[4]See *Hartford Accident & Indem. Co. v. Columbia Cas. Co.*, 98 F.Supp.2d 251, 259 (D. Conn. 2000) (finding material facts in dispute as to whether the reinsurer was bound by the "follow-the-settlements" provision of the reinsurance contract where the cedent's allocation may have reflected an effort to maximize the amount of reinsurance collected).

[5]*North River Ins. Co. v. ACE American Reinsurance Co.*, 361 F.3d 134 (2d Cir. 2004).

In *Travelers Cas. & Sur. Co. v. INA*,[6] the Third Circuit ruled in 2010 that the "follow the fortunes" applies to post-settlement allocation decisions and that insurers are not acting in bad faith as long as they cede such losses to reinsurers in a reasonable manner that can be justified independently of reinsurance considerations. Accordingly, an insurer is free to consider the reinsurance implications of its settlement so long as its cession reflects reasonable, businesslike decisions made in good faith.

Dow Corning sought coverage from Travelers for diverse liabilities, including breast implant claims and various chemical exposures. Ultimately, Travelers agreed to settle for a lump sum payment of $137 million. Of this amount, $80 million was stated in the agreement to be for the breast implant claims, $20 million for chemical product exposures and a remaining $37 million for unrelated claims. The insured also agreed to Travelers' request that the breast implant claims be treated as a single "occurrence." Further, the breast implant claims were agreed to involve "non-products" losses, whereas the chemical exposure claims were characterized as "products" claims. Of the $80 million allocated to breast implants, Travelers characterized the entire loss payment as indemnity, not defense.

Travelers lost little time in ceding the claim to its reinsurers. INA disputed the cession, questioning whether Travelers had (1) acted in bad faith by manipulating its rationale for the settlement to maximize reinsurance recoveries; (2) artificially compressed the amount allocated to the reinsurance period by eliminating any allocation to any AL policy issued after 1982; and (3) had similarly inflated its reinsurance recovery by improperly claiming that the limits of coverage in two three-year policies should be calculated on a "per year" basis. INA also criticized Travelers' refusal to treat any of the breast implant settlement as involving defense costs.

In the ensuing litigation in Philadelphia, the federal district court ruled in Travelers' favor, finding that although INA had reason to be suspicious, Travelers "did not act in bad faith and that its various decisions were reasonable, businesslike decisions made in good faith." Having ruled for Travelers in Phase One, the court found for INA in Phase Two, ruling that the three-year policies were subject to a single limit and should not have been annualized.

On appeal, the Third Circuit found that INA had failed to show that Travelers acted in bad faith by manipulating its post-

[6] *Travelers Cas. & Sur. Co. v. INA*, 609 F.3d 143 (3d Cir. 2010).

settlement allocation to maximize recovery under the reinsured layer of coverage. Recognizing that there is a dispute among the circuits with respect to whether the "follow the fortunes" doctrine should apply to post-settlement allocations—especially where, as here, the allocation decisions being challenged were not the product of active bargaining between the policyholder and the insurance company—the Third Circuit aligned itself with the majority view that the doctrine does apply to post-settlement allocations. Explaining, the Third Circuit declared that a contrary holding "would risk doing precisely what the follow the fortunes doctrine aims to prevent, interfering in settlement negotiations between insurers and their insureds by discouraging a particular type of settlement (here an all cash deal)."

While acknowledging that post-settlement allocation decisions must be made in good faith, the Third Circuit emphasized "that the insurers' negative duty not to make allocation decisions primarily in order to increase reinsurance recovery does not translate into a positive duty on the part of the insurer to minimize its reinsurance recovery." Accordingly, in order to prevail on a bad faith defense, the reinsurer must show more than that a particular allocation decision increased its obligations. Rather, the reinsurer must provide direct evidence that the insurer was motivated primarily by reinsurance considerations or else show that the after-the-fact rationales offered by the insurer are not credible.

In this case, the Third Court found that Travelers' decisions were reasonable and were not designed solely to maximize its reinsurance recovery. The Third Circuit disagreed with the District Court's conclusion that Travelers acted properly in excluding the post-1982 AL policies from its allocation. But even though it sided with INA on the substance of this argument, the Third Circuit found no bad faith. As it explained, "[b]ecause Travelers was under no duty to minimize its reinsurance recovery, the mere fact that it could have, consistent with its agreement with the insured, allocated it to all of the [rensured] policies does not mean that it was required to do so."

In one of the most significant reinsurance allocation cases decided to date, the New York Court of Appeals ruled in 2013 that a cedent's allocation decisions must be objectively reasonable and are not immune to challenge merely because the reinsurance cession mirrors the allocation assumptions that the insurer utilized in settling with its policyholder. In *USF&G v.*

American Re-Ins. Co.,[7] the Court of Appeals found that lower courts should not have ruled that the reinsurer must reimburse a cedent for a multi-million asbestos settlement where disputed issues of fact remained as to what portion of the settlement should be attributed to bad faith claims and whether USF&G inflated the value of non-meso claims to cover for the fact that it had not assigned any value for the insured's release of bad faith claims against USF&G.

The Court of Appeals' decision declared the courts should give significant deference to the ceding insurer's allocation, if only because the court could not think of a good alternative that would not open the door to "long litigation over complex issues that courts may not be well equipped to resolve." Rather, the court opined that "deference to a cedent's decisions makes for a more orderly and predictable resolution of claims."

The Court of Appeals emphasized, however, that there were limits to this deference. In particular, a reinsurer is only bound by allocation decisions that are made in good faith and are objectively reasonable. While an allocation is not unreasonable merely because it furthers the self-interest of the cedent (by increasing the reinsured recovery), "the reinsured's allocation must be one that the parties to the settlement of the underlying insurance claims might reasonably have arrived at in arm's length negotiations if the reinsurance did not exist."

Importantly, the Court of Appeals also ruled that reasonableness does not exist just because the cedent's reinsurance allocation methodology mirrors the assumptions used in settling with the policyholder. The court archly noted that "in many cases claimants and insureds[,] far from being indifferent, will enthusiastically support insurers' efforts to fund a settlement at reinsurers' expense."

Summing up the first phase of its opinion, the court declared:

> In sum, under a follow the settlements clause like the one we have here, a cedent's allocation of a settlement for reinsurance purposes will be binding on a reinsurer if, but only if, it is a reasonable allocation, and consistency with the allocation used in settling the underlying claim does not by itself establish reasonableness.

In the second phase of its opinion, the Court of Appeals proceeded to consider whether USF&G's allocation decisions in this case were reasonable as a matter of law in ceding this loss to its reinsurers based on the assumptions: (1) that all of the settlement amount was attributable to claims within the limits of

[7] *USF&G v. American Re-Ins. Co.*, 20 N.Y.3d 407, 985 N.E.2d 876 (2013).

USF&G's policies, and none of it to the claims that USF&G acted in bad faith when it refused to defend MacArthur in asbestos litigation; (2) that claims by claimants suffering from lung cancer had a value of $200,000 each, while certain other claims had values of $50,000 or less; and (3) that USF&G's entire payment should be attributed to the policy in force in 1959—the last full year in which USF&G was Western Asbestos's liability insurer. Could these assumptions "reasonably have been the basis for an arm's length settlement among the asbestos claimants, MacArthur and USF&G if reinsurance were not in the picture?"

In this case, it was clearly to USF&G's advantage not to attribute any portion of its settlement to the bad faith claims, as bad faith damages were not a reinsured "loss in connection with each policy." However, the court found that there was significant evidence that USF&G might have faced a bad faith verdict had it not settled. In particular, the court observed that a jury could have found that USF&G "knew, well before it admitted, that it did indeed provide such coverage, and that its litigation position was an irresponsible attempt to exploit the fact that, with the passage of time, the policies it issued had disappeared." The court suggested that even though USF&G's alternative argument that it did not owe coverage by "operation of law" to the corporate successor of its named insured might have been plausible, one reasonable basis for avoiding coverage did not nullify the bad faith denial on the basis of missing policies. The court took note of the fact that the California Superior Court had found questions of fact concerning USF&G's possible bad faith and had not only denied its motion for summary judgment on these grounds before trial, but had also denied, at the outset of the coverage trial, a motion in limine to exclude some evidence thought to be relevant to those claims.

In light of these facts, the Court of Appeals concluded that "it was therefore arguably not reasonable, at the time the coverage litigation was settled, to say that the bad faith claims had no value." Further, it found that USF&G might have assigned inflated values to non-meso claims to offset the lack of any valuation for bad faith. The court also took note of the fact that MacArthur had included a bad faith dollar demand in earlier negotiations with USF&G and that bad faith claims had been discussed with the Bankruptcy Court in approving a plan of reorganization for MacArthur. The court concluded, therefore, that:

> In short, we find it impossible to conclude, as a matter of law, that parties bargaining at arm's length, in a situation where reinsurance was absent, could reasonably have given no value to the bad faith claims. This issue must be decided at trial.

§ 8:13 Application of the "follow the fortunes" doctrine, generally—Disputes involving numbers of "occurrences"

In *Allstate Ins. Co. v. American Home Assurance Co.*,[1] a facultative reinsurer was held not obliged to accept American Home's cession of its payments to United Technologies to resolve environmental liability claims around the country on a "one site/ one "occurrence" basis where such arguments were inconsistent with the multiple "occurrences" position that the insurer had used against UTC in the original coverage litigation, a case in which AIG had also obtained a ruling for one of the sites that separate operations and contamination at the site involve multiple "occurrences." Unlike the trial court, the First Department was not swayed by a single occurrence analysis that had been prepared after the fact by coverage counsel. Rather, the court declared that, "A reinsurer is not bound by the follow the fortunes doctrine where the reinsured's settlement allocation, at odds with its allocation of the loss with its insured, designed to minimize its loss, reflects an effort to maximize unreasonably the amount of collectible reinsurance. The Appellate Division also ruled that American Home's argument that there was an "industry practice of ceding pollution claims to reinsurers on a single occurrence per site basis" was not only unsubstantiated but inconsistent with its own evidence.

In *Hartford Acc. & Ind. Co. v. Columbia Cas. Co.*,[2] a federal district court in Connecticut denied a cedent's motion for summary judgment that was premised on a "follow the settlements" provision in facultative certificates where there were facts that could support the inference that the cedent's conduct in allocating environmental liability to only one site was grossly negligent or reckless. The court found that the cedent's classification of the settlement as a single occurrence, where there were claims from over 50 different sites, may have been motivated by its desire to maximize reinsurance recovery and was done without following the customary practice of consulting an environmental expert.

[Section 8:13]

[1] *Allstate Ins. Co. v. American Home Assurance Co.*, 43 A.D. 3d 113, 837 N.Y.2d 138 (App. Div. 2007).

[2] *Hartford Acc. & Ind. Co. v. Columbia Cas. Co.*, 98 F. Supp. 2d 251, 258–60 (D. Conn. 2000).

Similarly, the Supreme Court of Connecticut ruled in *Hartford Acc. & Ind. Co. v. ACE American Reins. Co.*,[3] that a trial court erred in granting summary judgment to Hartford's reinsurers with respect to whether the 17,000 individual asbestos claims against Western MacCarthur could be aggregated to reach the reinsurers' layer. Whereas the Superior Court had ruled that the underlying claims could not be aggregated as involving "any one accident," the Supreme Court took the view that the common cause language was ambiguous and that further fact finding was needed to consider whether the underlying claims were "meaningfully related" and "arose out of the same pattern of events" so as to permit aggregation.

Under the terms of the relevant reinsurance contract, coverage only became available once a multimillion dollar threshold for "any one accident," which was defined as:

> Any one, or more than one accident, happening or occurrence arising or resulting from any one event, casualty or catastrophe upon which liability is predicted, under one, or more than one, of the policies covered by this Agreement, and, as respects liability arising out of products manufactured, made, handled, distributed or sold by an assured, liability arising out of property damage or out of malpractice, said term shall also be deemed and construed to mean any one, or more than one accident, happening, or occurrence which the available evidence shows to be the probable common cause or causes of more than one claim under a policy, or policies or renewals thereof irrespective of the time of the presentation of such claims to the assured or the Hartford.

At trial, the Superior Court found that the underlying claims were each a separate "occurrence" and that the workers' exposures did not have "sufficient commonality" to come within the meaning of the common clause language. However, the Supreme Court found that the "arising out of products" language in the common cause provision was as to whether it allows aggregation of claims that were "meaningfully related" and "arose out of the same pattern of events" as argued by Hartford or, as the reinsurers claimed, "incorporates spatial and temporal limitations" that preclude aggregation of claims that were incurred at hundreds of different locations and over decades. The case therefore remanded for further proceedings.

Most recently, a federal district court in New York ruled[4] that a cedent did not act unreasonably or in bad faith in allocating

[3] *Hartford Acc. & Ind. Co. v. ACE American Reins. Co.*, 284 Conn. 744, 936 A.2d 224 (2007).

[4] *Utica Mut. Ins. Co. v. Clearwater Ins. Co.*, 2016 U.S. Dist. LEXIS 6219

asbestos losses to the reinsured umbrella policies. In grant summary judgment to the cedent, the court declined to find any evidence that the loss allocation was motivated by reinsurance considerations and ruled, in any event that a cedent was not required to pick an allocation methodology that minimized its reinsurance recovery. In light of uncertainty with respect to whether its primary policies would be found to contain an applicable aggregate limit or not, the District Court ruled that the cedent acted reasonably in negotiating a settlement agreement that minimized its overall liability.

◆ **Practice Points for Cedents:**

Contemporaneous documentation of the legal and factual basis for settlement is a far more compelling basis for justifying a later reinsurance allocation than after the fact opinion letters received from outside counsel.

Regular reporting to reinsurers during the claims and settlement process may also alleviate or avoid later disputes.

The chronology of a settlement negotiation can be important evidence. Don't throw away notes and drafts!

Self-serving clauses in settlement agreements wherein the policyholder agrees to the reinsurer's position may be counter-productive unless there was real consideration for these concessions and evidence of a bona fide dispute on this issue before the settlement documents were executed.

◆ **Practice Points for Reinsurers:**

Is the insurer's position objectively reasonable in light of the law governing that particular dispute?

Has the insurer been consistent in its treatment of similar disputes in the past?

Has the insurer provided you with contemporaneous reports or legal opinions explaining its strategy in seeking to settle and the evolution of the eventual settlement agreement?

§ 8:14 Application of the "follow the fortunes" doctrine, generally—Miscellaneous sources of controversy

North River Ins. Co. v. CIGNA Reinsurance Corp.[1] involved a dispute between North River and its facultative reinsurance dispute over sums paid to Owens Corning under the Wellington Agreement. On September 20, 1993, Judge Bassler issued a

(N.D.N.Y. Jan. 20, 2016).

[Section 8:14]

[1] North River Ins. Co. v. CIGNA Reinsurance Corp., No. 91-1323 (D.N.J. September 20, 1993), reversed, 52 F.3d 1194 (3d Cir. 1995).

comprehensive opinion, ruling that the "follow the fortunes" clause in the facultative certificates did not obligate the reinsurers to reimburse North River for defense costs that were not provided for under the ceded policies, notwithstanding the fact that North River was had been ordered to pay such costs as the result of an adverse ADR ruling in the course of its Wellington participation. The Court further ruled that the reinsurers were freed of any obligations that they might otherwise have had due to North River's violation of its duty of utmost good faith in failing to notify reinsurers of its Wellington participation and its grossly negligent handling of the ADR proceeding that resulted in the imposition of defense costs as a penalty.

These findings were reversed on appeal by the Third Circuit. The Court ruled that CIGNA Re must follow its cedent's "fortunes" because the arbitrator's decision was not based solely on the Wellington Agreement but rather found support in the language of North River's excess insurance policies. Further, the Court ruled that the District Court erred in finding a breach of good faith and that CIGNA Re had in any event failed to show that it was prejudiced by North River's conduct.

The Appellate Division of the New York Supreme Court refused to hold that reinsurers were bound to follow the fortunes of National Union in paying $150 million to Monsanto to resolve numerous underlying toxic tort and environmental claims. In *American Home Assurance Co. v. Everest Re,*[2] the First Department ruled that although there was no evidence at all that National Union had acted other than in good faith in negotiating the Monsanto settlement, a disputed issue of fact did arise in light of the fact that only a few months after the settlement was reached, the Delaware Superior Court ruled in *Monsanto v. Aetna*[3] that such claims were subject to the "sudden and accidental"-type pollution exclusion.

§ 8:15 Application of the "follow the fortunes" doctrine, generally—Is there an emerging consensus?

It is apparent from the foregoing cases that courts are continuing to give deference to the ceding insurer's rationale and are reluctant to give reinsurers too much latitude in contesting the cedent's decision to settle. At the same time, courts are express-

[2]*American Home Assurance Co. v. Everest Re*, 90 A.D.3d 580, 936 N.Y.S.2d 20 (1st Dept. 2011).

[3]*Monsanto v. Aetna*, 1993 WL 563253 (1993), aff'd 653 A.2d 305 (Del. Super. 1994).

ing some skepticism about the rationale underlying some cessions.

At the same time, mere consistency between the underlying settlement and the cession is clearly not enough, in and of itself, to require payment. In many cases, the insured has no interest in a term that may be crucial to the reinsurance claim and will gladly agree to self-serving wordings that do not affect it but materially advance the cedent's potential recovery from its reinsurers.

At the same time, the mere fact that the insurer is acting to advance its own interests to the potential financial detriment of its reinsurers does not automatically invalidate its claim. As the Third Circuit observed in *Travelers v. INA*, Third Circuit emphasized "that the insurers' negative duty not to make allocation decisions primarily in order to increase reinsurance recovery does not translate into a positive duty on the part of the insurer to minimize its reinsurance recovery."[1]

To the extent that the foregoing authority can be synthesized, it appears that judicial analysis of reinsurers' duty to follow their cedents' fortunes is coalescing around several broad principles:

(1) A cedent's allocation methodology is entitled to considerable deference, even if it is contrary to positions that it articulated in the original coverage litigation or negotiations with its policyholder.
(2) "Follow the fortunes" applies both to pre- and post-settlement allocation decisions.
(3) The ceding insurer's allocation must be objectively reasonable, such that it might have resulted from arms length bargaining between the ceding insurer and the underlying policyholder without any consideration of the existence and terms of the reinsurance.
(4) The allocation must fairly reflect the claims that have been released.
(5) The cession must reflect a plausible interpretation of the law—mere reliance on some claimed industry custom and practice will not suffice.
(6) An reinsurer's duty to follow its cedent's fortunes does not require it to pay losses or amounts that are beyond what it contracted to reinsure.

[Section 8:15]

[1] 609 F.3d 143 (3d Cir. 2010).

§ 8:16 Do reinsurers have a duty to approve settlements in advance?

Owing to the importance of reinsurance to an insurer's business, insurers may sometimes consult with their reinsurers about the proposed terms of a settlement before agreeing to it. There is no specific requirement that the insurer do so, nor is there any requirement that reinsurers give their consent in advance. Nevertheless, such consultations may do much to alleviate some of the problems that are evident in the case examples in the preceding sections by affording reinsurers the opportunity to raise questions or concerns about how or why the claim is being settled and to give them insight into the cedent's own analysis of its potential liabilities.

§ 8:17 Reimbursement for the costs of coverage litigation?

Disputes with respect to whether reinsurers must reimburse ceding insurers for their costs of contesting the policyholder's claim rarely arise now as most reinsurance contracts explicitly include such costs within the reinsured loss. Disputes may still arise under agreements that were entered into prior to 2000 and that may lack such wordings, however.

In one of the earliest cases to consider this issue, the Supreme Judicial Court of Massachusetts ruled in *Affiliated FM Insurance Company v. Constitution Reinsurance Corporation*,[1] that where a facultative certificate promised that the reinsurer "shall pay its proportion of expenses [other than office expenses and payments to any salaried employee] incurred by the Reinsured in the investigation and settlement of claims or suits," the term "expenses" was ambiguous and must therefore be interpreted in accordance with the custom and usage of the insurance industry. (On remand, a Massachusetts jury ruled four years later that evidence of reinsurance custom and practice did require Constitution Re to pay Affiliated FM's coverage litigation costs.)

U.S. courts have sometimes required reinsurers to reimburse costs of coverage litigation on the basis that contractual language is ambiguous.[2] Others have found that the inclusion of a promise to pay the insurer's "expenses" clearly contemplates reimburse-

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[Section 8:17]

[1] *Affiliated FM Insurance Company v. Constitution Reinsurance Corporation*, 415 Mass. 839, 845 626 N.E.2d 878 (1994).

[2] See, e.g., *Fireman's Fund Ins. Co. v. General Reins. Corp.*, 2005 US Dist.

ment for the expense of coverage litigation. Thus, a federal district court ruled in *Employers Ins. Co. of Wausau v. American Re*,[3] that legal fees incurred in connection with a declaratory judgment action were encompassed by the reinsurer's promise to pay "all expenses incurred in the investigation and settlement of claims or suits." Similarly, in *Employers Re v. Mid-Continent Cas. Co.*,[4] the Tenth Circuit affirmed a Kansas court's ruling that the cost of coverage litigation was owed by a reinsurer who had promised to reimburse "all payments under the supplementary payments provision of the [cedent's] policy, including court costs, interest upon judgment, and allocated investigation, adjustment and legal expenses."

In the absence of similarly ambiguous wordings, the Second Circuit refused to imply a duty to reimburse such costs. At issue in *British International Ins. Co., Ltd. v. Seguros La Republica, S.A.*[5] were 26 facultative certificates that stated that the reinsurer "is subject to the same risks, valuations, conditions, endorsements (except changes to the location), assignments and adjustments as are or may be assumed, made or adopted by the reinsured, and loss, if any, hereunder is payable pro rata with the reinsured and at the same time and place . . ." The reinsurer argued that it should not owe declaratory judgment expenses because BIIC was not subject to any "risk" of having to reimburse its own declaratory judgment expenses. This argument was accepted by the U.S. District Court in Manhattan and, on appeal, by the Second Circuit. Despite BIIC's argument that the language should be interpreted in accordance with industry custom and usage in light of *Constitution Re*, the Second Circuit found that *Constitution Re* was clearly distinguishable, since the certificates in this case did not contain the "expenses" language that the Massachusetts Supreme Judicial Court had found to be ambiguous but that, furthermore, BIIC had failed to articulate any ambiguity in the language in question. Nor was the court willing to admit evidence of industry custom and usage in the absence of ambiguity. The Second Circuit also rejected BIIC's argument that the reinsurer was obligated to reimburse a pro rata share of its

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LEXIS 43650 (N.D. Cal. 2005) (costs of "investigation and settlement of claims or suits" held to potentially encompass costs of coverage litigation).

[3] *Employers Ins. Co. of Wausau v. American Re*, 256 F. Supp. 2d 923, 925 (W.D. Wis. 2003).

[4] *Employers Re v. Mid-Continent Cas. Co.*, 202 F. Supp. 2d 1221, 1235 (D. Kan. 2002) aff'd 358 F.3d 757, 768 (10th Cir. 2004).

[5] *British International Ins. Co., Ltd. v. Seguros La Republica, S.A.*, 324 F.3d 78 (2d Cir. 2003).

declaratory judgment expenses by operation of the "follow the fortunes" doctrine. The court found there was no basis for contending that BIIC's duty to pay its own costs of coverage litigation would "potentially within the coverage of the underlying policies." Such fees were purely for the benefit of the insurer and were not part of the coverage afforded to the policyholder.