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Follow the Fortunes and Allocation: An Update

By

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Abstract: In this article, the authors discuss the impact of recent cases from state and federal courts in New York on the evolution of the follow the fortunes doctrine. This principle has traditionally operated to protect cedents from having to re-litigate with their reinsurers issues resolved in the adjustment of the underlying claims. Some courts have interpreted these clauses to foreclose reinsurer inquiry not only into issues resolved through the settlement with the policyholder, but also to issues that may not have been relevant to the underlying claim adjustment, such as allocation of that settlement to different years and layers of a cedent's reinsurance program. This article examines the tension between the New York federal and state courts with respect to question of how expansively these clauses should be applied to allocation issues.

I. INTRODUCTION

The phrase "follow the fortunes" (or "follow the settlements"[1]) is familiar to all who work with reinsurance claims. Indeed, it is rare to see a reinsurance dispute without some discussion of the scope of this principle. Nonetheless, the question of what the proper boundaries of this doctrine should be, particularly with respect to allocation of settlements, remains open. In New York, there appears to be disagreement between the Second Circuit (the federal intermediate appellate court) and the state's intermediate appellate court as to the doctrine's application to allocation questions.

While the Second Circuit cases could be read to transform the doctrine from a contractual principle into a method for effecting the public policy of maximizing coverage, the decision from New York's appellate division applies a more limited interpretation of the role of follow the fortunes in the allocation context. In this article, we discuss the evolution of the doctrine, from its origins through the current tension between the New York federal and state cases.

II. THE ORIGIN OF FOLLOW THE FORTUNES CLAUSES

The concept of follow the fortunes developed in the early days of reinsurance as a contractual response to the burden cedents faced when trying to collect from their reinsurers.[2] Historically, reinsurers were not bound by adjudications of coverage rendered against their cedents or by their cedent's decisions to settle claims prior to adjudication. Even when facing an established liability to its insured, a cedent nonetheless had to independently prove coverage under the original policy (as well as under the reinsurance contract) in a proceeding against its reinsurer. In essence, this required a cedent to try any defense under the policy twice - once with the policyholder and then again with its reinsurer. And, in that second coverage dispute, the reinsurer could be expected to invoke all of the defenses the cedent had unsuccessfully asserted against the policy holder. Recovery would be even more difficult where a cedent compromised the underlying claim, as the reinsurer could argue that the payment was voluntary, not pursuant to requirements of the underlying policy.

U.S. case law recognized the cedent's predicament as long ago as the 19th Century. As Justice Story[3] observed in 1841:

> [T]he reassurers are entitled to make the same defence, and to take the same objections, which might be asserted by the original insurers in a suit upon the first policy....[A]s no voluntary payment by the original insurers would be binding or obligatory upon the reassurers, they are compellable to resist the payment, and to require the proper proofs of loss from the assured in a regular suit against them, so as to protect themselves by a bona fide judgment to the amount of recovery against them under their reassurance.

New York State Marine Ins. Co. v. Prot. Ins. Co., 18 F. Cas. 160, 160 (C.C.D. Mass. 1841).

Justice Story further explained, "[i]t was to avoid this inconvenience and delay, as well as peril, that the French policies of reassurance...usually contain a clause, allowing and authorizing the original insurers to make, bona fide, a voluntary settlement and adjustment of the loss, which shall be binding upon the reassurers." *Id.* Use of these clauses obviously spread beyond France. American reinsurance practice and case law embraced them by the 1800's. *See id.; Hastie v. De Peyster*, 3 Cai. R. 190 (N.Y. Sup. Ct. 1805).

Today, most reinsurance contracts contain provisions requiring the reinsurer to follow the fortunes or follow the settlements. Courts have always viewed these clauses with sympathy.[4] As stated by one court, the follow the fortunes principle protects the cedent from being placed "in the untenable position of advancing defenses in coverage contests that would be used against them by reinsurers seeking to deny coverage." *North River Ins. Co. v. CIGNA Reins. Co.*, 52 F.3d 1194, 1206 (3d Cir. 1995).

III. LIMITATIONS ON THE DOCTRINE

Even the most expansive modern cases refrain from interpreting a follow the fortunes clause as giving a cedent *carte blanche* to cede all losses. Indeed, a cedent's settlement is still subject to challenge as unreasonable, in bad faith, or clearly outside the scope of its policy. For example, follow the fortunes does not override an express exclusion or limitation on coverage in a contract of reinsurance. In *Bellefonte Reinsurance Co. v. Aetna Casualty & Surety Co.*, 903 F.2d 910 (2d Cir. 1990), the court addressed the question of whether defense costs paid by a cedent to its policy holder in excess of its policy limits were reimbursable by the reinsurer where those costs exceeded the limit of the reinsurance contract. The court held the reinsurer was not responsible for that portion of a settlement that exceeded the limits of the reinsurance contract. Specifically, the court noted, the "follow the fortunes clauses in the certificates are structured so that they coexist with, rather than supplant, the liability cap." *Id.* at 913.

The same reasoning controlled in *Travelers Casualty & Surety*

Co. v. Certain Underwriters at Lloyd's of London, a 2001 decision of the New York Court of Appeals (the state's highest court). 96 N.Y.2d 583 (N.Y. 2001). There, the court upheld a challenge to Travelers' allocation of environmental losses that its policyholders had incurred at numerous sites from different sources and over many years as one occurrence. Absent a one-occurrence allocation, there would be no reinsurance coverage. Travelers argued that because its allocation was reasonable and in good faith, the follow the fortunes doctrine mandated that reinsurers reimburse it, regardless of any inconsistent terms in the reinsurance contract.

The court rejected that argument. The court concluded that the definition of "disaster and/or casualty" contained in the reinsurance contracts was inconsistent with a one-occurrence treatment of the reinsurance claim. Like the Second Circuit in *Bellefonte, supra*, the court held that the follow the fortunes clause "does not alter the terms or override the language of the reinsurance policies." *Travelers*, 96 N.Y.2d at 596.[5]

Courts also routinely observe that the reinsurer does not have to follow the ceding company's fortunes where a settlement involves bad faith, fraud, or collusion. However, cases have set the bar high for a reinsurer seeking to make out such a claim. As stated in *American Bankers Insurance Co. v. Northwestern National Insurance Co.*, the standard for bad faith is "deliberate deception, gross negligence or recklessness...‘[B]ad faith requires an extraordinary showing of a disingenuous or dishonest failure to carry out a contract.'"

198 F.3d 1332, 1336 (11th Cir. 1999) (finding cedent's failure to investigate claim, which was not covered by the policy, did not rise to the standard of gross negligence or recklessness) (quoting *North River v. CIGNA*, 52 F.3d at 1216). Reinsurers have seldom met this standard.

IV. RECENT NEW YORK CASES APPLYING FOLLOW THE FORTUNES TO ALLOCATION

As discussed above, the traditional follow the fortunes rule precludes re-litigation of coverage issues resolved reasonably and in good faith by the ceding company through its settlement with the insured. At one time, many practitioners understood that follow the fortunes generally did not apply to questions relating to the allocation of a settlement to available years and layers of coverage or, by implication, to their respective reinsurance protections. However, recent cases demonstrate that this is no longer the state of the law in New York. The question now is how expansively courts are applying the doctrine to allocation questions.

A. The Second Circuit Decisions

Where a ceding company makes a lump sum payment in return for a general release, that settlement does not ordinarily resolve the issue of how the settlement should be allocated to the potentially implicated policies. Thus, the thinking goes that when a reinsurer challenges a ceding company's allocation of that settlement, the question of re-litigating an issue that had already been resolved does not exist because the allocation has not previously been presented. Reinsurers have traditionally argued that without the protection afforded by the arm's length settlement negotiation or judicial resolution that resolves matters of coverage, the issue of allocation frequently presents the risk of "moral hazard." In other words, the temptation to maximize reinsurance coverage might influence the ceding company's allocation.

Nonetheless, the Second Circuit has specifically applied follow the fortunes to allocation. In these cases, the court held that so long as the allocation is "in good faith, reasonable, and within the applicable policies" the reinsurer is bound to follow the cedent's allocation decision. *North River Ins. Co. v. ACE Am. Reins. Co.*, 361 F.3d 134, 141 (2d Cir. 2004); *see also Travelers Cas. & Sur. Co. v. Gerling Global Reins. Corp.*, 419 F.3d 181, 189 (2d Cir. 2005). In *North River v. ACE*, North River insured several layers of Owens-Corning Fiberglass Corporation's ("OCF") coverage and had paid out nearly its entire limits for product liability coverage. Thereafter, OCF sought to recover substantially more for its exposure to thousands of additional, "non-product" claims. North River initially denied coverage, but later settled all of the claims for $335 million in return for a full release. It then allocated ninety-nine percent of its settlement to its nine years of coverage as one occurrence, using the "rising bathtub"[6] approach. Under that analysis, the settlement fell entirely within the second layer excess and therefore North River sought to collect reinsurance exclusively from its second layer reinsurers, of which ACE was one.

ACE argued that the follow the fortunes doctrine was inapplicable to North River's allocation of the settlement -- as distinguished from the settlement itself -- and sought to challenge the allocation on the grounds that it contradicted North River's pre-settlement analyses. Specifically, ACE noted that those analyses identified risk of loss to the higher layers. ACE argued it should not have to contribute to that portion of the settlement that, under North River's pre-settlement analyses, reflected risk to the layers above the second layer excess.

The court rejected ACE's argument. It explained, "the main rationale for the [follow the fortunes] 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.'" *North River v. ACE*, 361 F.3d at 140-41 (brackets in original) (quoting *North River v. CIGNA*).

Thus, the Second Circuit interpreted the rule as potentially precluding any complex factual analysis, whether the issue to be decided was addressed by the settlement or not. It said, "it 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." *North River v. ACE*, 361 F.3d at 141. The court concluded:

> Therefore, the court holds 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. Id.

The court reached a similar conclusion in *Travelers Casualty & Surety Co. v. Gerling Global Reinsurance Corp.* 419 F.3d 181 (2d Cir. 2005). Relying on *North River v. ACE, supra*, which presented analogous and related facts, the court repeated its public policy rationale for the doctrine and declined to "authorize an inquiry into the propriety of a cedent's method of allocating a settlement if the settlement itself was in good faith, reasonable, and within the terms of the polices." *Gerling*, 419 F.3d at 189 (citations omitted).

Further, the court rejected Gerling's reliance on the decision of the New York Court of Appeals in *Travelers Casualty & Surety Co. v. Certain Underwriters at Lloyd's of London*, *supra*, for the proposition that New York law limited application of follow the fortunes to the cedent's settlement as opposed to its allocation of the settlement payment.[7] That decision, the court said, had turned on the explicit occurrence definition contained in the controlling reinsurance treaties. *Gerling*, 419 F.3d at 189-90.

Instead, the court said:

> [A] cedent's post-settlement allocation is subject to follow-the-fortunes, regardless of any pre-settlement position taken by the cedent, whether that position is articulated in a pre-settlement risk analysis, or implicit in the settlement with the underlying insured.

Id. at 188.

The court also rejected Gerling's bad faith arguments. Specifically, Gerling argued that the allocation of thousands of diverse non-product asbestos claims that arose over a period of many years as one occurrence was intrinsically unreasonable and evidenced bad faith. This was so, it said, both because no court had ever upheld a one-occurrence treatment of similar facts and because the chosen allocation maximized reinsurance. The court disagreed. It held that allocation based on a novel legal theory did not constitute evidence of bad faith or disingenuousness. *Id*. at 191. The court also concluded that Gerling's maximization of coverage argument was not supported by the facts. The court went on to say that "[a]n 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." *Id*. at 193. This language left little room for a future challenge to an allocation based on maximization of coverage.

B. *Allstate Insurance Co. v. American Home Assurance Co.*

A recent case from the Appellate Division of New York (an intermediate appellate court) appears to support a more limited view of the application of follow the fortunes to allocation. *Allstate Insurance Co. v. American Home Assurance Co*. arose out of a dispute over environmental pollution at several different sites. 837 N.Y.S.2d 138 (N.Y. App. Div. 2007). In the underlying litigation, the insured repeatedly argued in favor of multiple occurrences at each of the sites. And, the trial court found multiple occurrences, at least with respect to one of the sites, prior to the settlement. However, the insured sought coverage from its reinsurer on the basis of a single occurrence. Absent that allocation, it would not have satisfied the retention on the reinsurance policy.

In apparent contrast to the Second Circuit in the *Gerling* case, the court found the inconsistency between the allocation at the claim level and reinsurance recovery stage evidence of bad faith. The court balked at the idea of

> Lend[ing its] imprimatur to defendant's playing by two sets of rules: one applied at the insured's claim level where the occurrence deductible is used as often as possible to minimize the amount of the insurer's exposure and loss, and later, in the same loss setting, another, where the occurrence deductible is used as sparingly as possible to maximize the reinsured's recovery against the reinsurer. 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. We soundly reject 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.

Allstate, 837 N.Y.S.2d at 143.

Further, the *Allstate* court rejected the argument, based on *North River v. ACE and Gerling*, supra, that its determination required either an "intrusive factual inquiry" into defendant's allocation or any inappropriate "second guessing" of its settlement decisions. Instead, the court held:

> 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.

Id. at 144.

While the state court did not reject the notion that follow the fortunes applies to allocation, it did not embrace the Second Circuit's expansive view of the rationale for the doctrine or its limited view of a court's ability to drill down into the cedent's motive for its chosen allocation method.

IV. CONCLUSION

As the discussion above demonstrates, the state of the law in New York as to the application of follow the fortunes is developing. On the one hand, the Second Circuit cases that potentially transform follow the fortunes from a contractual tool to a public policy based on "maximizing coverage" indicate a possible expansion of reinsurance coverage. On the other hand, the *Allstate* case suggests that, in certain circumstances, courts might look into the facts of the case and question the motivation behind a cedent's allocation method in determining whether the cedent's actions were in good faith. Wherever the case law goes, the effect on the industry might nevertheless be limited because arbitration panels decide the majority of reinsurance disputes, and panels generally are not bound to adhere strictly to legal precedents.

Endnotes:

[1] While historic research show distinct origins for the terms "follow the settlements" and "follow the fortunes," U.S. Courts now commonly use them interchangeably to describe the principle that restricts a reinsurer's right to dispute liability for its cedent's loss settlements, and in some cases, allocation of loss. *See e.g.* P.T. O'Neill & J.W. Woloniecki, *The Law of Reinsurance in England and Bermuda* 172-74 (2d ed. 2004). For convenience, we will use the term "follow the fortunes" here.

[2] One commentator has traced such clauses back to French reinsurance contracts in use in the early 1700's and to French judgments enforcing them in the mid 1700's. William C. Hoffman, *Common Law of Reinsurance Loss Settlement Clauses: A Comparative Analysis of the Judicial Rule Enforcing the Reinsurer's Contractual Obligation to Indemnify the Reinsured for Settlements,* 28 Tort & Ins. L.J. 659, 664 (1993).

[3] Justice Story, then a member of the U.S. Supreme Court, sat as a Circuit Justice in that case.

[4] The courts appear to be split as to whether follow the fortunes clauses can be implied into reinsurance contracts. *See, e.g. Int'l Surplus Lines Ins. Co. v. Certain Underwriters & Underwriting Syndicates at Lloyd's of London*, 868 F. Supp. 917, 920 (S.D. Ohio 1994) (follow the fortunes applies to all reinsurance contracts, regardless of whether or not they contain an express clause); cf. *Am. Ins. Co. v. Am. Re-Ins. Co.*, 2006 WL 3412079, at *4-5 (N.D. Cal. Nov. 27, 2006) (finding that "the majority of courts addressing this issue, and the better reasoned opinions" have rejected the idea that a follow the fortunes clause should be read into policies as a matter of law); *Employer's Reins. Corp. v. Laurier Indem. Co.*, 2007 U.S. Dist. LEXIS 45670, at *7-11 (M.D. Fla. June 25, 2007) (declining to find the contract's silence on the issue of follow the fortunes an ambiguity and holding that follow the fortunes will not be implied into the reinsurance certificate); *Am. Motorists Ins. Co. v. Am. Re-Ins. Co.*, 2007 U.S. Dist.

LEXIS 41257, at *17 (N.D. Cal. May 29, 2007) (refusing to read a follow the settlements provision into a contract containing no such clause).

[5] The court also noted a distinction between review of a ceding company's decision to settle and its allocation of the settlement to its reinsurance coverage. Because of this distinction it deemed the follow the fortunes authorities cited by Travelers to be "inapposite." *Id.* at 597.

[6] The "rising bathtub" approach calls for allocation on the basis of horizontal exhaustion, meaning that "losses are allocated to the lowest layer of coverage first and, like a bathtub, fill from the bottom layer up. Under that approach, a given layer is not implicated until the layer beneath it is completely exhausted." *North River v. ACE*, 361 F.3d at 138 n.6.

[7] *See supra* note 5 for the portion of the state court *Travelers* decision that ACE relied upon for this argument.