REINSURANCE 101:
FUNDAMENTAL REINSURANCE CONCEPTS

KEVIN D. LEWIS
SIMPSON THACHER & BARTLETT LLP

MARCH 20-21, 2003

MEALEY'S FUNDAMENTALS OF INSURANCE COVERAGE LAW CONFERENCE

March 20-21, 2003

Westin Hotel
Philadelphia, Pennsylvania

REINSURANCE 101:
FUNDAMENTAL REINSURANCE CONCEPTS

I. UTMOST GOOD FAITH

It is often said that the relationship between a ceding insurer and a reinsurer is one *uberrimae fidei, i.e.*, one "of utmost good faith." Although the exact boundaries of the doctrine have not been defined, the doctrine is often described in terms of the disclosures required in an insuring relationship. Black's Law Dictionary defines *uberrima fides* as

> The most abundant good faith; absolute and perfect candor or openness and honesty; the absence of any concealment or deception, however slight. A phrase used to express the perfect good faith, concealing nothing, with which a contract must be made; for example, in the case of insurance, the insured must observe the most perfect good faith toward the insurer.

Black's Law Dict. 1520 (6th Ed. 1990).

One commentator has contrasted the duty of utmost good faith with the doctrine of *caveat emptor*, "let the buyer beware", in which there are expectations that both parties to the contract will have the ability to examine thoroughly what is being exchanged. V. Vitkowsky,

The Evolving Meaning of The Duty of Utmost Good Faith, Mealey's Litigation Reports: Reinsurance, vol. 5, no. 6 (July 27, 1994).

A. Origins of the Doctrine

The doctrine of utmost good faith can be traced to both civil and English common law. *See generally* B.R. Ostrager & M.K. Vyskocil, Modern Reinsurance Law and Practice § 3.01[d] (2d Ed. 2000); G.S. Staring, Law of Reinsurance § 8.1 (1993). For example, in the 18th century, Lord Mansfield recognized in *Carter v. Boehm*, 97 Eng. Rep. 1162, 1164 (K.B. 1766), that the insuring relationship turns on the accuracy of the disclosures made to the underwriter:

> The special facts, upon which the contingent chance is to be computed lie most commonly in the knowledge of the insured only: the underwriter trusts to his representations and proceeds upon confidence that he does not keep back any circumstance in his knowledge, to mislead the underwriter into a belief that the circumstance does not exist, and to induce him to estimate the risque, as if it did not exist. The keeping back such circumstance is fraud, and therefore the policy is void. Although the suppression should happen through mistake, without fraudulent intention, yet still the underwriter is deceived, and the policy is void . . . .

In the early 19th century, the United States Supreme Court recognized the doctrine as applying to insurance generally:

> The contract of insurance has been said to be a contract *uberrimae fidei*, and the principles which govern it are those of an enlightened moral policy. The underwriter must be presumed to act upon the belief, that the party procuring insurance, is not, at the time, in possession of any facts, material to the risk which he does not disclose . . . .

McLanahan v. Universal Ins. Co., 26 U.S. 170, 185 (1828) (holding that even where there may be no intent to defraud, a failure to disclose material facts to the underwriter known to the purchaser of insurance at the time of purchase would result in voiding the policy).

An early case applying the doctrine to reinsurance can be found in *New York Bowery Fire Ins. Co. v. New York Fire Ins. Co. of City of N.Y.*, 17 Wend. 359, 367 (N.Y. Sup. Ct. 1837), where the court held that the reinsured must disclose all information material to the risk known at the time of contract formation: "[w]hether the omission was the result of mistake or design, was not an important inquiry. The assured acts at his peril in withholding information."

B What is Required by the Duty of Utmost Good Faith

It has been widely held that the duty of utmost good faith runs in both directions, *i.e.*, both the reinsured and reinsurer each owe the other a duty of utmost good faith. *See, e.g., Compagnie de Reassurrance d'Ile de France v. New England Reinsurance Corp.*, 57 F.3d 56, 88 (1st Cir.), *cert. denied*, 516 U.S. 1009 (1995); *Mentor Ins. Co. v. Norges Brannkasse*, 996 F.2d 506 (2d Cir. 1993); *United Fire & Casualty Co. v. Arkwright Mutual Ins. Co.*, 53 F. Supp. 2d 632 (S.D.N.Y. 1999); *Commercial Union Ins. Co. v. Seven Provinces Ins. Co.*, 9 F. Supp. 2d 49, 69 (D. Mass. 1998), *aff'd*, 217 F.3d 33 (1st Cir. 2000).

1. The Duty Owed by Cedents

Although the duty of utmost good faith is generally understood to apply equally to reinsureds and reinsurers, because it is most often expressed in terms of the duty of disclosure at the time of contracting, it is more often invoked by reinsurers seeking to resist claims asserted by their cedents. Thus the Second Circuit Court of Appeals has stated: "[t]he relationship between a reinsurer and a reinsured is one of utmost good faith, requiring the reinsured to disclose to the reinsurer all facts that materially affect the risk of which it is aware and of which the reinsurer itself has no reason to be aware." *Christiania General Ins. Corp of N.Y. v. Great American Ins. Co.*, 969 F.2d 268, 278 (2d Cir. 1992). *See Transamerica Leasing, Inc. v. Institute of London Underwriters*, 267 F.3d 1303, 1308 (11th Cir. 2001) (holding that the doctrine of utmost good faith "requires that an insured fully and voluntarily disclose to the insurer all facts material to a calculation of the insurance risk").

A recent decision of the Eighth Circuit described the duty as follows:

> Reinsurance relationships are governed by the traditional principle of 'utmost good faith.' The duty of good faith is essential to the industry, inasmuch as reinsurers depend on ceding insurers to provide information concerning potential liability on the underlying policies. Reinsurers must rely on this principle because they generally do not duplicate the functions of the ceding insurers, such as evaluating risks and processing claims. To arrange their business otherwise would result in greatly increased costs for both reinsurance and the underlying policies themselves.

Reliastar Life Ins. Co. v. IOA Re, Inc., 303 F.3d 874, 877-78 (8th Cir. 2002).

Although the disclosure requirements imposed on the cedent under the doctrine of utmost good faith suggest that a prudent ceding insurer will disclose all known material facts, once put on notice of potential issues, the reinsurer bears the responsibility of evaluating or making further inquiry with regard to those issues. *See Old Reliable Fire Ins. Co. v. Castle*

Reinsurance Co., 665 F.2d 239, 244 (8th Cir. 1981). A ceding insurer's disclosure obligations may be satisfied by providing the reinsurer with access to information from which the material facts concerning the risk may be evaluated. *See* E. Wollan, Handbook of Reinsurance Law, § 3.03. A ceding insurer is under no obligation, however, to disclose facts already known to the reinsurer. *See Compagnie de Reassurance d'Ile de France v. New England Reinsurance Corp.*, 57 F.3d 56, 80 (1st Cir. 1995); *China Union Lines, Ltd. v. American Marine Underwriters, Inc.*, 755 F.2d 26, 29 (2d Cir. 1985); *A/S Ivarans Rederei v. Puerto Rico Ports Authority*, 617 F.2d 903, 905 (1st Cir. 1980); *Sumitomo Marine & Fire Ins. Co. v. Cologne Reinsurance Co.*, 75 N.Y.2d 295, 303, 552 N.Y.S.2d 891, 895 (1990).

Although a cedent fails to make a material disclosure at its peril, the First Circuit Court of Appeals has stated, in the context of a claim by a reinsurer against a retrocessionaire, that an "innocent" misrepresentation is insufficient to establish a breach of the duty of utmost good faith:

> We agree that a reinsurer like NERCO, having obtained by treaty the power to impose significant risks and liabilities upon plaintiff retrocessionaires, owed to them the utmost good faith in its dealings under the treaties. This means that, as the district court properly recognized, defendants owed plaintiffs a duty "to exercise good faith and to disclose all material facts." In the non-marine context, however, a claim of fraud may not be founded on innocent misrepresentation and concealment. Thus, the district court properly required the plaintiff to prove that the defendant made a false representation of a material fact with knowledge of its falsity for the purpose of inducing the plaintiff to act thereon, and that the plaintiff relied upon the representation as true and acted upon it to his damage."

Compagnie de Reassurance D'Ile de France v. New England Reinsurance Corp., 57 F.3d 56, 72-73 (1st Cir. 1995) (citations omitted).

Although most courts hold that non-disclosure of a material fact is sufficient to establish a breach of the duty of utmost good faith, regardless of whether the non-disclosure was intentional or inadvertent, some courts have required the reinsurer to establish that it has been prejudiced by the non-disclosure before coverage will be voided. *See, e.g., North River Ins. Co. v. Cigna Reinsurance Co.*, 52 F.3d 1194, 1212-16 (3d Cir. 1996) (reinsurer must show gross negligence or recklessness by cedent and that the reinsurer suffered resulting economic injury); *Compagnie de Reassurance d'Ile de France v. New England Reinsurance Corp.*, 944 F. Supp. 986, 994 (D. Mass. 1996) (rescission of reinsurance contracts warranted only where reinsured acted in bad faith or where reinsurers suffered prejudice from non-disclosure). *See also Unigard Sec. Ins. Co. v. Kansa General Ins. Co.*, 42 F.3d 1402 (9th Cir. 1994) (retrocessionaire must show prejudice arising from reinsurer's bad faith to void retrocession contract).

2. The Cedent's Duty as Fiduciary in Nature

Because of the nature of the reinsurance relationship, *i.e.,* the reinsurer's reliance on the information provided to it by the cedent, some courts have described the relationship as fiduciary in nature, especially in the context of treaty reinsurance. *See, e.g., Compagnie de Reassurance d'Ile de France v. New England Reinsurance Corp.*, 944 F. Supp. 986, 996 (D. Mass. 1996) *Mutuelle Generale Francaise Vie v. Life Assurance Co.*, 688 F. Supp. 386, 397-98 (N.D. Ill. 1988).

As explained by the U.S. District Court for the District of Massachusetts in the context of treaty reinsurance:

> Both *uberrimae fidei* and fiduciary duty arise out of a relationship of vulnerability. In the case of a fiduciary, this relationship may sometimes result from an inherent vulnerability, as in the case of a layman who trusts a doctor, but more often it arises out of a purely conventional understanding that one party is permitted, as a matter of law, to trust the other in the managing of certain affairs. A bankruptcy trustee, for example, may be no more sophisticated than the creditors of the bankrupt estate. Nor may a corporate director be more sophisticated than his shareholder. In these situations, the law recognizes that vigilant monitoring of the fiduciary by a beneficiary would be impractical and would undermine the benefit that the relationship is intended to create.
>
> Similarly, the relationship between reinsured and reinsurer under a reinsurance treaty is one of profound vulnerability. By entering into a proportional reinsurance treaty, a reinsurer essentially becomes the "silent partner" of the reinsured. Every risk that the reinsured chooses to cede under a treaty automatically imposes a risk on the reinsurer. All discretion lies with the reinsured and the reinsurer must "follow the fortunes" of the reinsured by indemnifying it for all payments made to its insureds in good faith. The reinsurer relies on the "utmost good faith" of the reinsured and the reinsured is aware of this.

Compagnie de Reassurance d'Ile de France v. New England Reinsurance Corp., 944 F. Supp. 986, 996 (D. Mass. 1996), *on remand from* 57 F.3d 56 (1st Cir. 1995). Even though the District Court found a fiduciary duty running from the cedent to its treaty reinsurer, the court specifically noted that such a relationship does not exist with respect to facultative reinsurance, which "does not entail the same degree of vulnerability as does a treaty relationship, since, unlike the treaty reinsurer, the facultative reinsurer has the ability to pick and choose the risks it will take, and may, like an ordinary insurer, investigate those risks in advance." *Id.* at 996-97.

A clear majority of courts, however, have held that the reinsurance contract does not create a fiduciary relationship between the cedent and the reinsurer. *See, e.g.*, *North River Ins. Co. v. Cigna Reinsurance Co.*, 52 F.3d 1194, 1212-13 (3d Cir. 1996); *Christiania General Ins. Corp. v. Great American Ins. Co.*, 979 F.2d 268, 280-81 (2d Cir. 1992); *American Special Risk Ins. Co. v. Greyhound Dial Corp.*, No. 90 Civ. 2066 RPP, 1996 U.S. Dist. LEXIS 14231 (S.D.N.Y. Sept. 26, 1996); *International Ins. Co. v. Certain Underwriters at Lloyd's of London*, No. 88 C 9838, 1991 U.S. Dist. LEXIS 12948 (N.D. Ill. Sept. 16, 1991); *International Surplus Lines Ins. Co. v. Fireman's Fund Ins. Co.*, No. 88 C 320, 1989 U.S. Dist. LEXIS 15626 (N.D. Ill. Dec. 29, 1989), *aff'd*, 998 F.2d 504 (7th Cir. 1993); *Morrison Assurance Co. v. North American Reinsurance Co.*, 588 F. Supp. 1324 (N.D. Ala. 1984), *aff'd*, 760 F.2d 279 (11th Cir. 1985). *See also United States v. Brennan*, 183 F.3d 139 (2d Cir. 1999) (overturning a criminal conviction resulting from an erroneous jury finding of a fiduciary relationship in a reinsurance transaction).

As stated by the Second Circuit: "because these contracts are negotiated at arms length by experienced insurance companies, there is no reason to label the relationship as 'fiduciary.'" *Christiania,* 979 F.2d at 280-81. However, notwithstanding its holding in *Christiania*, the Second Circuit has held that the duty of utmost good faith, while perhaps not creating a fiduciary relationship, does create a "special" relationship between the cedent and reinsurer:

> Because information regarding risks lies with the ceding insurer, the reinsurance market depends on a high level of good faith to ensure prompt and full disclosure. Absent such disclosure, reinsurers would have to duplicate actuarial and claims-handling efforts of ceding insurers, and reinsurance would become unavailable. Courts should thus adopt information-forcing default rules based on the good faith the reinsurance market demands.

Unigard Security Ins. Co. v. North River Ins. Co., 4 F.3d 1049, 1066 (2d Cir. 1993).

3. The Reinsurer's Duty to Its Cedent

Several courts have found that reinsurers (or retrocessionaires) owe a duty of utmost good faith to their cedents, usually in the context of a failure to pay the cedent's claims in good faith. *See, e.g., Compagnie de Reassurance d'Ile de France v. New England Reinsurance Corp.*, 57 F.3d 56, 88 (1st Cir. 1995); *American Special Risk Ins. Co. v. Greyhound Dial Corp.*, No. 90 Civ. 2066 (RPP), 1996 U.S. Dist. LEXIS 14231 (S.D.N.Y. 1996); *Arkwright Mutual Ins. Co. v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, No. 90 Civ. 7811 (AGS), 1995 U.S. Dist. LEXIS 11 (S.D.N.Y. Jan. 4, 1995); *Travelers Ins. Co. v. Keeling*, No. 24376/91-002, 003 (N.Y. Sup. Ct. N.Y. Co. 1994).

In *Commercial Union Ins. Co. v. Seven Provinces Ins. Co.*, 9 F. Supp. 2d 49, 69 (D. Mass. 1998), the court found the reinsurer to be in violation of the duty of utmost good faith for

engaging in a "moving target" strategy resulting in protracted delays in paying the cedent's claims, by denying the existence of the reinsurance certificates, continually changing its requests for information, questioning the cedent's decision to settle with the underlying insured, and proposing numerous alternative allocations. The court found that the reinsurer's "behavior was particularly egregious when seen in the context of the mores of the reinsurance industry, an industry which has operated for centuries on the principle of 'utmost good faith.'" *Id.* The First Circuit affirmed the district court's ruling, stating that:

> Utmost 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.

217 F.3d 33, 43 (1st Cir. 2000).

C. Continued Vitality of the Doctrine

The doctrine of utmost good faith developed at a time when reinsurance relationships reflected "traditions of trust and mutual reliance" in an industry where the reinsurance agreement was seen as an "honorable engagement." *See Commercial Union Ins. Co. v. Seven Provinces Ins. Co.*, 9 F. Supp. 2d 49, 69 (D. Mass. 1998). As one commentator has noted "[i]nsurers and reinsurers operated by an informal code of conduct under which they were often prepared to compromise disputes, rather than undermine a long-lasting relationship of trust." E. Wollan, Handbook of Reinsurance Law § 3.02 (2002).

While reinsurance disputes in the past may have been resolved amicably, in recent years, ever increasing environmental and toxic tort liabilities faced by direct insurers have placed significant pressures on reinsurance relationships, resulting in an increase in reinsurance litigation and arbitration. As a result, some courts and commentators have called into question the continued viability of a doctrine less suited to the arms-length relationships that are the hallmark of the industry today than the "old boy network" of reinsurance professionals that historically populated the industry. *See, e.g.*, *Unigard Sec. Ins. Co. v. North River Ins. Co.*, 4 F.3d 1049, 1066 (2d Cir. 1993); S.M. Thomas, *Utmost Good Faith in Reinsurance: A Tradition in Need of Adjustment*, 41 Duke L.J. 1548, 1558-61 (1993); D.F. Cohen, T.E. DeMasi & A. Krauss, *Uberrimae Fidei and Reinsurance Rescission: Does a Gentlemen's Agreement Have a Place in Today's Market?*, 29 Tort & Ins. L.J. 602, 604 (1994).

Reinsurers, however, continue to rely on *uberrima fides* as the basis for the reinsurance relationship, especially in the context of treaty reinsurance, where arguably there are more significant limitations on the ability of treaty reinsurers to assess risks they have contracted to share. As noted by the District of Massachusetts, "in spite of the strain on the doctrine of

uberrimae fidei, however, it continues to be a controlling legal principle in the reinsurance industry." *Commercial Union Ins. Co. v. Seven Provinces Ins. Co.*, 9 F. Supp. 2d 49, 69 (D. Mass 1998).

II. FOLLOW THE FORTUNES

A. Basic Principles

It is a fundamental principle of reinsurance law that a reinsurer is bound to "follow the fortunes" of its reinsured on all risks encompassed by the reinsured policy. As stated by the Second Circuit, the follow the fortunes doctrine "burdens the reinsurer with those risks which the direct insurer bears under the direct insurer's policy covering the original insured." *Bellefonte Reinsurance Co. v. Aetna Casualty & Surety Co.*, 903 F.2d 910, 912 (2d Cir. 1990); *see American Marine Ins. Group v. Neptunia Ins. Co.*, 775 F. Supp. 703, 708 (S.D.N.Y. 1991), *aff'd*, 961 F.2d 372 (2d Cir. 1992). One might say that the follow the fortunes doctrine complements the cedent's duty of utmost good faith: where the cedent conducts itself in the utmost good faith, the reinsurer is bound to follow that cedent's fortunes.

A corollary to the follow the fortunes doctrine is that a reinsurer must also follow the good faith and reasonable settlements of claims paid by the reinsured. Thus, a reinsurer is required to reimburse the cedent for its payment of settled claims so long as the claim payment is arguably within the terms of the reinsured policy. *De novo* review of the cedent's determination to make such payments is not permitted. *See, e.g.*, *American Bankers Ins. Co. of Fl. v. Northwestern Nat'l Ins. Co.*, 198 F.3d 1332, 1335 (11th Cir. 1999); *North River Ins. Co. v. CIGNA Reinsurance Co.*, 52 F.3d 1194, 1206 (3rd Cir. 1995); *Mentor Ins. Co. (U.K.) Ltd. v. Norges Brannkasse*, 996 F .2d 506, 516 (2d Cir. 1993); *North River Ins. Co. v. Ace American Reinsurance Co.*, 00 Civ. 7993 (JSR), 2002 U.S. Dist. LEXIS 5536 (S.D.N.Y. Mar. 29, 2002 (appeal pending); *Commercial Union Ins. Co. v. Seven Provinces, Ins. Co.*, 9 F. Supp. 2d 49, 66 (D. Mass 1998), *aff'd*, 217 F.3d 33 (1st Cir. 2000), *cert. denied*, 531 U.S. 1146 (2001); *International Surplus Lines Ins. Co. v. Certain Underwriters at Lloyd's*, 868 F. Supp. 917, 920-21 (S.D. Ohio 1994); *Unigard Sec. Ins. Co. v. North River Ins. Co.*, 762 F. Supp. 566, 587 (S.D.N.Y. 1991), *rev'd in part, aff'd in part,* 4 F.3d 1049 (2d Cir. 1993).

Accordingly, the scope of review of a cedent's claims payments is necessarily narrow – the mere fact that the reinsurer would have handled the underlying claim differently is an insufficient basis upon which to deny the reinsured's claim. As stated by the Second Circuit: "[a] reinsurer is required to indemnify for payments reasonably within the terms of the original policy, even if technically not covered by it." *Christiania Gen. Ins. Co. v. Great American Ins. Co.*, 979 F.2d 268, 280 (2d Cir. 1992). The New York Court of Appeals has similarly held that the follow the fortunes doctrine "leaves reinsurers little room to dispute the reinsured's conduct of the case. In addition, the interests of both parties are furthered through the primary insurer's efficient investigation and defense of the claim and through the resolution of the claim on the

best terms possible." *Unigard Sec. Ins. Co. v. North River Ins. Co.,* 79 N.Y.2d 576, 583, 584 N.Y.S.2d 290, 293 (1992). As long as the underlying settlement with the insured was made in good faith and arguably within the scope of coverage of the direct insurance policy, the reinsurer pays "as the insurer pays." *Insurance Co. of New York v. Associated Mfrs' Mutual Fire Ins. Corp.*, 74 N.Y.S. 1038, 1039 (App. Div. 1st Dep't 1903).

As a result of the duty of utmost good faith, reinsurers may rely on their cedent's good faith claims investigation, handling and settlements. The follow the fortunes doctrine is a necessary extension of the duty of utmost good faith and benefits both cedents and reinsurers by avoiding the expense and delay that would inevitably result from duplicative claims handling by reinsurers. *See generally* B.R. Ostrager & M.K. Vyskocil, Modern Reinsurance Law & Practice, § 9.02 (2d Ed. 2000).

The follow the fortunes doctrine is so fundamental to the operation of reinsurance that the clear majority view in the United States is that it applies in every contract of reinsurance, even when it is not expressly provided for in the language of the contract itself. *See, e.g.*, *Mentor Ins. Co. (U.K.) Ltd v. Norges Brannkasse*, 996 F.2d 506, 516 (2d Cir. 1993 ("Custom and practice in reinsurance includes the principle of 'follow the fortunes.'"); *Aetna Casualty & Surety Co. v. Home Ins. Co.,* 882 F. Supp. 1328, 1350 (S.D.N.Y. 1995) ("[I]t is customary within the reinsurance industry for reinsurers to follow the claim settlement decisions of the ceding company even in the absence of an explicit loss settlements clause."); *International 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 doctrine applies to all reinsurance contracts even if not formally expressed in reinsurance agreement). *But see North River Ins. Co. v. Employers Reinsurance Corp.*, No. CV-2-00-1221, 2002 U.S. Dist. Lexis 7118 (S.D. Ohio Mar. 11, 2002) (whether follow the settlements clause was implied in facultative reinsurance contract was issue for trier of fact).

Although many courts have held that a follow the fortunes clause may be implied, many reinsurance contracts nevertheless contain such clauses, which assume many different forms. Graydon Staring notes at least 18 different versions of a follow the fortunes or follow the settlements clause:

- Reinsurer to "pay as may be paid"
- Reinsurer to "pay as may be paid and follow their settlements"
- Reinsurer to "pay as may be paid liable or not liable"
- Reinsurer will "in all respects follow the fortunes of the Reassured and pay as may be paid"
- Reinsurer to "follow the settlements"

- Reinsurer to "follow the settlements whether liable or not liable"
- Reinsurer's "liability shall follow [cedent's]"
- Reinsurer to "abide by the loss settlements"
- Claims involving the reinsurance, "when settled by the [reinsured], shall be binding upon the reinsurer"
- Settlements "shall be binding on [reinsurer] . . . whether the settlement be in full or in compromise"
- Settlement of claims "under the strict policy conditions or under a compromise or otherwise . . . shall be unconditionally binding on [reinsurers]"
- All "settlements made by the Reassured whether by way of compromise, ex gratia or otherwise shall in every respect be unconditionally binding"
- Reinsurer to be "bound by all such decisions provided only that the decisions are reasonable and are otherwise in compliance with the provisions of this agreement"
- "All loss settlements . . including compromise settlements . . . shall be binding . . . providing such settlements are within the terms and conditions of the original policies . . . and . . . this Reinsurance"
- Reinsurers to pay only "total constructive compromised and/or arranged total loss"
- Reinsurance to be "subject to the same risks, valuations, conditions and adjustments as are or may be taken by the reinsured"
- Reinsurance to be "subject to the same risks, valuations, conditions and mode of settlements as are or may be adopted or assumed."
- Reinsurance to be "subject to all terms, clauses, conditions and settlements as original but only to cover in respect of Total and/or Constructive and/or Arranged and/or Compromised Total Loss of Unit"

G.S. Staring, Law of Reinsurance § 18:3 (Mar. 1997).

B. Underlying Purpose

The rule barring *de novo* review of a reinsured's good faith coverage determinations serves multiple goals: (i) the rule permits a ceding insurer to fulfill its obligation to its policyholder to resolve coverage issues in good faith without fearing that by doing so it may forfeit reinsurance protection or subject itself to costly litigation with its reinsurers; (ii) the rule promotes the strong public policy in favor of encouraging settlement; (iii) the rule avoids imposition on the cedent of a double standard, where the same policy language is interpreted in favor of the policyholder in the direct insurance context under rules of construction designed to maximize insurance coverage, but in favor of the reinsurer in the reinsurance context under different rules of construction; and (iv) the follow the fortunes doctrine keeps dollars flowing uninterrupted along the risk transfer chain. *See North River Ins. Co. v. Cigna Reinsurance Co.*, 52 F.3d 1194, 1204 (3d Cir. 1995). *See also Mentor Ins. Co. v. Norges Brannkasse*, 996 F.2d 506, 517 (2d Cir. 1993). ("Mentor could not have long delayed payment for reasons related to the collectibility of reinsurance without breaching its obligation to its policyholder."). As stated by Judge Newman of the Southern District of New York:

> The purpose of the follow the settlements doctrine is to prevent the reinsurer from "second- guessing" the settlement decisions of the ceding company. Absent such a rule, an insurance company would be obliged to litigate coverage disputes with its insured before paying any claims, lest it first settle and pay a claim, only to risk losing the benefit of reinsurance coverage when the reinsurer raises in court the same policy defenses that the original insurer might have raised against its insured. This doctrine adjusts the incentives present in the reinsurance relationship in order to promote good faith settlements by the ceding company. Thus, where as to the relevant provision there is concurrency of coverage between the ceding company's policy and the policy of reinsurance, the follow the settlements doctrine imposes upon the reinsurer a contractual obligation to indemnify the ceding company for payments it makes pursuant to a loss settlement under its own policy, provided that such settlement is not fraudulent, collusive or otherwise made in bad faith, and provided further that the settlement is not an ex gratia payment.

Aetna Casualty & Surety Co. v. Home Ins. Co., 882 F. Supp. 1328, 1346 (S.D.N.Y. 1995) (internal citations omitted).

Because a ceding insurer's and reinsurer's interests are generally aligned when a cedent disclaims coverage, the follow the fortunes doctrine precludes the reinsurer from using the coverage defenses asserted by the insurer in the direct insurance context against the cedent in the reinsurance context. *See Christiania General Ins. Corp. of N.Y. v. Great American Ins. Co.*, 979 F.2d 268, 280 (2d Cir. 1992) ("A reinsurer cannot second guess the good faith liability

determinations made by its reinsured, or the reinsured's good faith decision to waive defenses to which it may be entitled."); *Commercial Union Ins. Co. v. Seven Provinces Ins. Co.*, 9 F. Supp. 2d 49, 66 (D. Mass. 1998); *International Surplus Lines Ins. Co. v. Certain Underwriters & Underwriting Syndicates at Lloyd's of London*, 868 F. Supp. 917, 921 (S.D. Ohio 1994).

C. Application of the Doctrine

1. Coverage Determinations vs. Settlements

Whether a reinsurer must follow its cedent's fortunes may turn upon whether the reinsured's liability was the result of a binding coverage determination in litigation or arbitration, or a compromise settlement, between the cedent and the underlying policyholder. As one might expect, when a cedent pays a claim as a result of a binding coverage determination by a court or arbitrator, there is little room for the reinsurer to challenge the claim.

For example, the Third Circuit Court of Appeals reversed a district court's ruling in favor of a reinsurer where the reinsured's direct insurance claim payment was the result of a binding arbitration ruling in favor of the underlying policyholder. *North River Ins. Co. v. Cigna Reinsurance Co.*, 52 F.3d 1194 (3d Cir. 1995). Such a rule makes sense where the reinsured denies coverage in the direct insurance context and the interest of the reinsured and reinsurer are aligned – as the reinsurer would benefit from the success of the reinsured in the underlying coverage litigation, so too should the reinsurer bear the consequences where the reinsured is unsuccessful in defending against the underlying claim.

Although a cedent can be fairly secure in relying on a binding coverage determination by a court or arbitrator, a cedent's compromise settlement is still subject to only minimal review to determine whether the settlement was reasonable in light of the facts and circumstances of the case and made in good faith. A *de novo* review of the reinsured's coverage determination and compromise is not permitted as it would be inconsistent with the strong public policy favoring settlements of disputes:

> Were the Court to conduct a de novo review of [the cedent's] decision-making process, the foundation of the cedent-reinsurer relationship would be forever damaged. The goals of maximum coverage and settlement that have been long established would give way to a proliferation of litigation. Cedents faced with a de novo review of their claims determinations would ultimately litigate every coverage issue before making any attempt at settlement.

International Surplus Lines Ins. Co. v. Certain Underwriters and Underwriting Syndicates at Lloyd's of London, 868 F. Supp. 917, 921 (S.D. Ohio 1994).

2. Extra-Contractual Obligations

Liabilities of the reinsured to its policyholder that do not arise out of the direct insurance contract, *e.g.*, liabilities arising from bad faith claims handling, may not be subject to reimbursement under a reinsurance contract. *See, e.g.*, *Employers Reinsurance Corp v. American Fidelity & Casualty Co.*, 196 F. Supp. 553 (W.D. Mo. 1959); *Duber Indus. Sec. Inc. v. Allendale Mutual Ins. Co.*, Civ. No. 69133 (Cal. Ct. App. 2d Dist. Feb. 16, 1984). However, where the reinsurance contract has a "judgment in excess of policy limits" clause, a claim for extra-contractual liability may be made under the reinsurance contract, depending on the circumstances of the liability and the specific language of the clause. For example, a reinsurer's participation in the handling of the underlying claim was held to be a factor in the reinsurer's liability for extra-contractual bad faith damages. *See Ott v. All-Star Ins. Corp.*, 299 N.W.2d 839 (Wis. 1981) (holding that by participating in claims handling activities, reinsurer had "acquiesced" in the insurer's actions, subjecting the reinsurer to reimbursement of the cedent's extra-contractual liabilities).

3. Ex *Gratia* Payments

An *ex gratia* payment, literally one that is "out of grace," is one that falls squarely outside the coverage of the direct insurance policy, and therefore, is not within the coverage of the reinsurance contract. An insurer may have very good business reasons for paying an otherwise uncovered claim, especially if there is a present, continuing underwriting relationship between the insurer and insured, but those reasons may not justify imposing a similar obligation on the reinsurer.

Generally, it is the cedent's burden to establish a *prima facie* case of coverage, whereupon it is left to the reinsurer to establish that the settled claim could not reasonably be deemed to fit within the coverage afforded by the reinsured policy, or that the settlement was the result of fraud or collusion on the part of the cedent. *See North River Ins. Co. v. Cigna Reinsurance Co.*, 52 F.3d 1194, 1207 (3d Cir. 1995); *Christiania Gen. Ins. Corp. v. Great American Ins. Co.*, 979 F.2d 268 (2d Cir. 1992); *American Ins. Co. v. North American Reinsurance Corp.*, 452 N.W.2d 841 (Mich. Ct. App. 1990); *State Auto Mutual Ins. Co. v. American Re-Insurance Co.*, 748 F. Supp. 556 (S.D. Ohio 1990).

The reinsurer's burden is not an easy one to overcome – as noted by one court: "The reinsurer bears the burden of showing bad faith on the reinsurer's [sic] part. The standard is a high one: the reinsurer must show "gross negligence or recklessness," or that the settlement was not even "arguably" within the scope of the reinsurance coverage. The reinsurer cannot dispute good faith determinations that a risk was covered by the underlying insurance policy, or good faith interpretations of policy terms." *Commercial Union Ins. Co. v. Seven Provinces Ins. Co.*, 9 F. Supp. 2d 49, 66 (D. Mass 1998).

D. Allocation and Aggregation of Losses

Ceding insurers are often faced with claims from their policyholders that may involve more than one individual plaintiff or insured location, and span multiple policy periods, especially in the areas of environmental and toxic tort liability claims. There may be many issues that the insured and insurer will have to address before coverage under the direct insurance policies can be settled, *e.g.*, when does injury/damage occur, does injury/damage occur in one year or more than one year triggering more than one policy, does each claimant/location constitute a separate occurrence or do all of the injuries/damage arise from a single occurrence? In resolving such claims insurers will necessarily have to address which insurance policies are triggered by the losses claimed upon and the number of occurrences applying to each policy. There is no single trigger or allocation theory that can be said to apply to all situations – rather, courts have applied a variety of trigger and allocation theories to suit the particular circumstances of the case.

While the law concerning the application of the follow the fortunes doctrine to binding coverage determinations and an insured's settlements is fairly well settled, there is considerable controversy over whether the doctrine also applies to the insured's post-settlement allocation of the loss to the direct insurance policies. If the settlement agreement between the cedent and insured explains how the settlement was reached, *i.e.,* which policies are triggered and how much of the settlement payments are attributable to each policy year, then the reinsurer is bound by that settlement provided it was reasonable and made in good faith, without regard to the availability or not of reinsurance coverage. A reinsured that structures a settlement in a manner specifically designed to maximize its reinsurance recovery, however, does so at the peril of losing its reinsurance recovery. *See United States v. Brennan*, 183 F.3d 139 (2d Cir. 1999).

It is possible that the insured and insurer may be able to resolve their dispute and settle the claim without achieving express agreement on how all or even any of the coverage issues should be individually resolved. In such a situation, the question arises as to whether the reinsurer is bound to follow not only the reinsured's settlement of the claim, but also the allocation of that settlement to direct insurance policies, which impacts the allocation to reinsurers.

This issue has been squarely addressed in several recent decisions. In *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), *cert. denied*, 531 U.S. 1146 (2001), the reinsured was faced with a claim for environmental damage from its policyholder arising from several locations spanning several policy years. The reinsured settled the claim but did not specifically address in the settlement agreement how much of the settlement payment was attributable to each location and to each of several insurance policies. The reinsurer challenged the reinsured's submission of the claim, arguing that it was improperly allocated.

The District of Massachusetts held that, while styled as a challenge to the reinsured's allocation, much of the reinsurer's arguments improperly attacked the settlement itself, *e.g.*, whether or not certain losses should have been excluded under particular provisions of the direct insurance policy, which is prohibited under the follow the fortunes doctrine. 9 F. Supp. 2d at 67. Significantly, the court described the challenge to the reinsured's allocation (rather than the settlement) as a "distinction without a difference." In applying the follow the settlements doctrine to the cedent's allocation, 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 loses are covered by the policies. Both are issues of judgment that the reinsured must be allowed to make for the sake of encouraging settlement. Review of either type of decision has an equal likelihood of undermining settlement and fostering litigation.
>
> Most settlements of complex environmental claims necessarily involve a number of sites, a range of years in which the exposure could have occurred, and – if the reinsured and the insured have an ongoing relationship – more than one policy of insurance. If a reinsured could be forced into litigation over its good faith judgment as to which policies covered which losses, it would be impossible for it to come to any settlement of such complex claims. When several reinsurers are involved, there would be a risk of successive litigations, in which each reinsurer offered an alternative allocation model that would reduce its own liability.

9 F. Supp. 2d at 67-68.

The court also noted that there are four major theories of when environmental damage triggers insurance coverage and four methods for allocating losses among insurance policies, resulting in sixteen possible options for allocating an environmental loss:

> A ceding insurer could, in good faith, select any one of sixteen options, only to have its various reinsurers each propose an alternative formula. If the "follow the settlements" principle did not apply to the allocation of those settlements, litigation would surely proliferate.

Id. at 68.

Judge Rakoff of the Southern District of New York recently adopted the First Circuit's reasoning in *Seven Provinces* in a case involving reinsurance of asbestos liabilities:

> Whenever settlements are made in cases involving multiple policies and multiple insurers and reinsurers, numerous good faith methods of allocation will be available and under consideration, but only one will ultimately be chosen in terms of the payments actually made. To allow reinsurers to second-guess that allocation would be to make settlement impossible and reinsurance itself problematic.

North River Ins. Co. v. Ace American Reinsurance Co., No. 00 Civ 7993 (JSR), 2002 U.S. Dist. LEXIS 5536 (S.D.N.Y. Mar. 29, 2002) (appeal pending).

The Eleventh Circuit Court of Appeals has also held that a retrocessionaire must follow its reinsured's good faith determination that liabilities for multiple breast implant claims constituted a single occurrence. *American Bankers Insurance Co. of Fl. v. Northwestern Nat'l Ins. Co.*, 198 F.3d 1332 (11th Cir. 1999). In *American Bankers,* Hartford Insurance Company had settled the claims of Dow Chemical in connection with autoimmune breast implant litigation. The Hartford billed that settlement to its reinsurer, American Bankers, who paid the claim. Northwestern National, a retrocessionaire of American Banker, refused to pay American Bankers' claim, arguing that American Bankers "had not acted reasonably in paying Hartford's claim" because although Hartford had paid Dow's claims on an aggregate basis, it had billed American Bankers on a per occurrence basis.

In addressing whether American Bankers had acted reasonably, such that Northwestern would be obligated to follow American Bankers' fortunes, the court stated that a reinsured's allocation decisions can only be challenged if the reinsured was deliberately deceptive, grossly negligent or reckless:

> This is not to say that there are no limitations on the [follow the fortunes] doctrine. A court must still ask whether the ceding insurer acted in good faith in settling or paying the claims. This in turn requires that we determine what constitutes good faith in this context. We are persuaded that simple negligence cannot be enough to establish bad faith. Virtually every decision by the ceding insurance company could be second-guessed and litigated under a simple negligence standard. Thus to equate bad faith with simple negligence would vitiate all of the policy reasons that give rise to the follow the fortunes doctrine. Rather we agree with the Second Circuit that the proper minimum standard for bad

> faith should be deliberate deception, gross negligence or recklessness.

198 F.3d at 1336. *See also Hartford Accident & Indemnity Co. v. Columbia Casualty Co.*, 98 F. Supp. 2d 251 (D. Conn. 2000) (adopting a "gross negligence or recklessness" standard for determining whether a reinsured's allocation of environmental losses at more than 50 sites as a single occurrence was reasonable and made in good faith, and leaving it to the jury as factfinder to determine whether the reinsurer would be required to follow the settlements of its reinsured under the specific facts and circumstances of the case).

The New York Court of Appeals recently decided another case involving the issue of whether the follow the fortunes doctrine applies to allocations, rejecting the aggregation of multiple occurrences under direct insurance policies into a single loss under reinsurance treaties. *Travelers Casualty & Surety Co. v. Certain Underwriters at Lloyd's of London*, 96 N.Y.2d 583, 734 N.Y.S.2d 531 (2001). In this case, the reinsured had settled claims in connection with environmental liabilities arising at more than 160 locations. The reinsured allocated the settlement to direct insurance policies on the basis of one occurrence per location, but submitted a claim to its treaty reinsurers on an aggregated basis, *i.e.,* as a single "disaster and/or casualty" under the reinsurance treaties in question in light of the definition of "disaster and/or casualty" in the treaties as including "a series of accidents, occurrences and/or causative incidents having a common origin . . . ." 96 N.Y.2d at 589, 734 N.Y.S.2d at 535.

The court rejected the application of the follow the fortunes doctrine on the ground that the allocation to the reinsurance treaties was inconsistent with the specific language in those treaties concerning the manner in which losses could be aggregated:

> While a "follow the fortunes" clause in most reinsurance agreements leaves reinsurers little room to dispute the reinsured's conduct of the case . . . such a clause does not alter the terms or override the language of the reinsurance policies. . . . To hold that these follow the fortunes clauses supplant the definition of "disaster and/or casualty" in the reinsurance treaties and allow [the reinsured] 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.

96 N.Y.2d at 596-97, 734 N.Y.S.2d at 540-41.

Whether or not the Court of Appeals correctly interpreted the "disaster and/or casualty" language in the reinsurance treaty, the Court's ruling on whether the follow the fortunes doctrine applies to allocations could be interpreted as holding that a claim should be allocated and presented to reinsurers as it was settled, *i.e.,* the allocation for reinsurance purposes should not deviate from the allocation to the direct insurance policies. Thus, had the claim been allocated and presented to reinsurers on a multiple-occurrence basis, it is far from clear that the court would not have bound the reinsurers to that allocation.