DISCOVERY IN REINSURANCE ALLOCATION DISPUTES

AFTER USF&G V. AMERICAN RE

By

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I. Introduction

Reinsurance allocation disputes arose out of mass torts that extend over multiple years and impact on many individuals or properties *i.e.* pollution and asbestos-related losses. When a cedent settles such losses, allocation to reinsurers can become complicated given the attachment points and limits on reinsurance coverage plus changes in reinsurers over the impacted years. Formulating the number of occurrences, the value of each occurrence and the year(s) in which the occurrence(s) took place can determine whether or not the cedent collects (and the reinsurers pay) very little or a great deal of reinsurance recoverables.

There is a significant amount of caselaw that applies the principle of follow the settlement (sometimes called follow the fortunes) to allocation issues.[1] In general (and with certain exceptions not addressed herein), the principle of follow the settlements means that the reinsurer will not second-guess the cedent's good faith settlement decisions.[2] The purpose of this article is to explore selected caselaw on the issue of what factual inquires will be allowed and considered by courts in order to determine whether the cedent's allocations are in good faith. In particular, this article will examine the recent decision of the New York Court of Appeals in *USF&G v. American Re-Insurance,* 985 N.E.2d 876 (N.Y. 2013) and its progeny, *Travelers Indem. Co. v. Excalibur Reinsurance Corp.*, 2013 U.S. Dist. Lexis 50134 (D.Ct).[3]

II. Prior Caselaw

Some prior caselaw in the Second Circuit Court of Appeals suggests that an inquiry into the facts of the underlying settlement and allocation thereof to reinsurers in order determine whether bad faith is present is inapposite to the principle of follow the settlements.

For instance, based on the facts of the underlying settlement, the reinsurer challenged the application of the principle of follow the settlements in *North River Ins. Co. v. Ace American Reinsurance Co.,* 361 F.3d 134 (2nd Cir. 2004). The court rejected this approach:

> [T]he main rationale for the doctrine [of follow the settlements] 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 cedent-reinsurer relationship."
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> These goals are served by upholding [the cedent's] allocation here. [The reinsurer's] appeal relies for its success not only on its theory regarding the limits of the follow-the-settlements doctrine, but also on the specific factual information on which it alleges [the cedent] relied in its settlement negotiations. But 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.[4]

In *Travelers Casualty & Surety v. Gerling Global Reinsurance Corp.,* 419 F.3d 181 (2nd Cir. 2005) the reinsurer challenged an allocation as differing from the basis upon which the claim was settled. The court again rejected such a fact-based approach:

> [W]e decline 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 policies. . . . Given that [the cedent] and [the insured] expressly declined to resolve the occurrence issue, there is no cause for us to do so now. Indeed, were we to undertake such an analysis, we would be engaging in precisely the kind of "intrusive factual inquiry" that the follow-the-fortunes doctrine was meant to avoid.[5]

If a reinsurer is not allowed to delve into and argue the facts of the underlying settlement and the cedent's allocation methodology, it is hard to understand how the reinsurer could demonstrate a bad faith allocation, if such is the case. Stated differently, is the bad faith exception to follow the settlements illusory if the reinsurer cannot discover facts on point and/or the court is not willing to consider arguments based thereon?

III. USF&G v. American Re-Insurance Company

This case involved the allocation of a very large asbestos-related group of losses. The trial court granted the cedent summary judgment on the basis of follow the settlements and this ruling was reversed in part by the New York Court of Appeals. At the Court of Appeals level, the reinsurers were challenging the allocation principally on three bases: (1) the allocation implicitly included bad faith claims which were excluded from the reinsurance cover; (2) certain types of claims were over-valued in order to penetrate the attachment point of the excess of loss reinsurance; and (3) all the losses were allocated to only one year of treaty coverage.

The court observed that follow the settlements creates "little risk of unfairness" when the interests of cedent and the cedent and reinsurer are aligned but that "application of a follow the settlements clause to allocation decisions raises problems, because in that context the interests of the cedent and

reinsurer will often conflict."[6] The court further observed that the allocation decisions of a cedent is worthy of deference but that "is not to say that they are immune from scrutiny."[7]

The court adopted a standard of objective reasonableness which allows the cedent to consider its own financial interests. The court stated:

> In sum, under a follow the fortunes 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.[8]

The Court of Appeals went on to examine the factual allegations and related arguments, reversing the summary judgment ruling as to the first and second points above and affirming on the third. Stated differently, the reinsurers were entitled to a trial on the facts of the cedent's bad faith exposure and its valuation of certain types of asbestos-related claims in order to determine whether the cedent's allocation was in bad faith.

IV. **Travelers Indemnity Co v. Excalibur Reinsurance Corp.**

This case involved a motion to compel discovery in a dispute over the allocation of certain errors and omissions losses to certain years in which Excalibur was the reinsurer. A Memorandum and Scheduling Order, referenced in the decision, explained that the cedent issued four annual claims made errors and omissions policies to a broker and that Excalibur was the reinsurer during only two of those years. Travelers allocated the loss to one of these years and Excalibur sought discovery as to the year in which the claim was actually "made" against the insured. Travelers argued that under the principle of follow the settlements, Excalibur could not challenge the allocation and, therefore, such discovery could not constitute or lead to admissible evidence.

Since the case was to be decided under New York law, the district court looked to *USF&G v. American Re* for guidance, quoted from it extensively and ultimately followed it. The court summarized Excalibur's argument as follows:

> The case for Excalibur is that as one of the reinsurers, it is entitled in law to challenge the amount Travelers allocated to it on two factual grounds: the allocation was unreasonable in the circumstances and it imposes a liability contrary to the terms (coverage dates) of the reinsurance contracts. The follow the settlements clause does not preclude those challenges. The dates when Claimants' underlying claims were first asserted against the Broker, the Insured, are essential elements of the challenges. Excalibur is entitled to discovery into that and other relevant circumstances.[9]

The court granted Excalibur's motion to compel holding:

> I conclude that . . . Excalibur's position is in accord with New York law and Travelers' is contrary to that law. Excalibur is entitled under the New York Court of Appeals cases to challenge the reasonableness of Travelers' post-settlement allocation decision, and to argue that the economic consequences of that allocation violates or disregards provisions in the reinsurance contract. The discovery Excalibur seeks may lead to evidence admissible on those issues.[10]

V. Conclusion

It remains to be seen whether the *USF&G v. American Re* standard for challenging allocation decisions will hold sway over the standards articulated in other jurisdictions.[11] Perhaps future courts will take from this decision, and that of *Travelers Indemnity Co v. Excalibur Reinsurance Corp.,* the need: (a) to allow reinsurers to gather the facts necessary to examine the good or bad faith nature of the allocation; and (b) for the court to examine these facts and the argument therefrom derived in ruling on the allocation. Otherwise the bad faith exception to the follow the settlement principle is illusory.

ENDNOTES

1 *See generally* Robert M. Hall and Debra J. Hall, *Are Standards Emerging for Allocation to Reinsurers via Follow the Settlements,* Reinsurance Vol. 3 No. 7 at 4 (2010) (hereinafter "Hall and Hall") and Robert M. Hall and Matthew T. Wulf, *Allocation to Reinsurers and Follow the Fortunes,* Mealey's Reins. Rpt. No. 19 at 26 (2003). (Both articles are available on the author's website: robertmhall.com).

2 *Id.*

3 The author thanks Michael Goldman, Esq., a partner with Mound Cotton Wollan and Greengrass in New York City, who provided supporting documents for this case. Mr. Goldman successfully argued the case for Excalibur.

4 361 F.3d 134 at 141 (Internal citations omitted).

5 419 F.3d 181 at 189 (Internal citations omitted).

6 986 N.E.2d 876 at 881.

7 *Id.* at 882.

8 *Id.* at 883.

9 2013 U.S. Dist. Lexis 50134*27.

10 *Id.* at *29-30.

11 *See generally,* Hall and Hall.