FOLLOW THE SETTLEMENTS AND *EX GRATIA* PAYMENTS

By

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I. Introduction

The follow the settlements doctrine is that reinsurers should not second guess the settlements of their cedents which are reasonably within the coverage provided to policyholders. There are a number of exceptions or limitations on this doctrine.[1] One such exception is that the settlement by the cedent must not be *ex gratia i.e.* outside the coverage provided by the cedent to the policyholder and assumed by the reinsurer. The purpose of this article is to explore the selected caselaw related to this exception.

II. Changes to Underlying Coverage Not Reinsured

One example of the manifestation of this exception is the recent case of *American Home Assurance Co. v. American Re-Insurance Co. et al*, Index No. 602485/06 (S.C.N.Y. May 24, 2010). This was a ruling on a summary judgment motion by which the reinsurers sought to dismiss claims by the cedent for reimbursement of pollution-related losses incurred by its insured, the Monsanto Company. American Home and Monsanto reached a series of agreements related to coverage for clean-up costs and third party claims and negotiated several modifications to such agreements. It does not appear that the reinsurers were completely aware of or consented to these agreements or modifications thereof. When the cedent billed the reinsurers, they raised several defenses, including the argument that certain settlements were *ex gratia* with respect to the policy terms that they reinsured.

In essence, the court found that the cedent adjusted and paid the Monsanto claims based not on the policy terms but on the subsequent agreements the cedent reached with Monsanto. The court found that the settlement: (a) included punitive damages which was excluded by the relevant policies; (b) included non-sudden pollution which was excluded with such exclusion in conformance with the law in the relevant state; and (c) ignored the proper application of Monsanto's self-insured retention and other insurance provisions of the relevant policies. As a result, the court granted summary judgment in favor of the reinsurers.

A somewhat similar case is *Granite State Ins. Co. v. ACE American Reinsurance Co.,* 2007 N.Y. App. Div. Lexis 13268. The cedent issued seven policies to the insured, only one of which (the Granite State policy) was assumed by the reinsurer. The cedent initially denied coverage under the Granite State policy but when it overpaid a loss on another policy, entered into an agreement with the insured to the effect that the overpayment would be covered by the Granite State policy. The court denied summary judgment motions concerning follow the settlements and the *ex gratia* exception thereto on the basis that there were outstanding issues to be resolved by the trier of fact.

North River Ins. Co. v. Philadelphia Reinsurance Corp., 831 F.Supp. 1132 (D.N.J. 1993) involved a policy issued to Owens-Corning which did not cover the insured's defense costs. When asbestos-related losses arose, the insured and North River attempted to have them handled pursuant to the Wellington Agreement. North River failed to file the relevant policy as not covering defense costs as required by the Wellington Facility and the insured claimed defense costs. Several Wellington ADR proceedings found the cedent liable for defense costs. The court found that the policy unambiguously excluded defense costs and that payment of such was *ex gratia* with respect to the reinsurance coverage. The court went on to find that the cedent violated its duty of utmost good faith to reinsurers:

> [B]y gross negligence in: (1) failing to recognize how signing the Wellington Agreement materially expanded the defense obligation under the Owens-Corning policies, and (2) triggering the strict penalty in Appendix D of the (Wellington) agreement by failing to schedule the policies (as not covering defense costs) within the 20-day period. These two acts of gross negligence constitute a material breach of the re-insurance certificates which mandated that (the reinsurer) consent to any modification of the risks re-insured.[2]

III. Payment of Non-Covered Damages

American Ins. Co. v. North American Co. for Prop. and Cas. Ins., 697 F.2d 70 2nd Cir. 1982) involved a layer of casualty reinsurance for $250,000 excess of $250,000 on a policy issued to Dow Chemical. Due to the presence of a Dow product in a building that burned, the court awarded the owner of the building $146,970 in compensatory damages and $750,000 in punitives. The cedent settled this and similar claims with the insured and allocated $500,000 to the burned building loss. The cedent argued that the definition of covered damages in the relevant policy was ambiguous and, in any case, the reinsurer was required to pay the loss pursuant to the doctrine of follow the settlements.

The court found that the policy issued to Dow Chemical did not cover punitive damages awarded for corporate misconduct, as was the case in this matter. Since the compensatory damages were below the attachment point of the reinsurance, the court found that the cedent was seeking compensation for punitive damages which was an *ex gratia* claim. The court found further that the doctrine of follow the settlements does not apply to *ex gratia* claims.

An attempt to collect reinsurance recoverables for extra-contractual damages was the issue in *National Union Fire Ins. Co. v. Clearwater Ins. Co.*, 2007 U.S. Dist. Lexis 52770 (S.D.N.Y.). The underlying claims involved breast implants manufactured and sold by 3M. The litigation with insurers was split into two

phases with the first dealing with coverage issues and the second dealing with the insured's extra-contractual damages resulting from the insured's lost profits due to the insurers' failure to pay defense and indemnity costs. During the second phase, the relevant insurer settled the entire dispute and argued that the reinsurer was obligated to pay its portion of the settlement pursuant to follow the settlements. The court denied the cedent's motion for summary judgment on the basis that there was evidence that a portion of the settlement included extra-contractual (*i.e. ex gratia)* losses.

IV. Wrongful Payment of Claim

In *Independent Ins. Co. v. Republic Nat. Life Ins. Co.,* 447 S.W.2d 462 (Ct.Civ.App.Texas 1969), the CEO of the primary company took out a life insurance policy on the life of an employee on behalf of a separate enterprise in which the CEO was the beneficial owner. After the policy lapsed for non-payment, the employee died. The cedent, nonetheless, paid the claim and sought to collect 95% of the claim from the reinsurer. The court rejected the cedent's follow the settlements argument:

> It is generally held that by such type of stipulation the reinsurer submits itself to any settlement or adjustment of liability on the original policy which (the) reinsured may adopt or assume in good faith. However, it is also settled that a provision of a reinsurance contract authorizing (the) reinsured to settle or adjust a claim of the original insured does not authorize the reinsured to impose liability on the reinsurer by settlement or adjustment of a claim for which no liability exists, as a matter of law. The reinsurer may attack a settlement for fraud or collusion.[3]

Lexington Ins. Co. v. Prudential Reinsurance Co. of America, 1997 Mass. Super. Lexis 593 involved a comprehensive general liability policy purchased by a bank which provided a revolving credit account to an auto dealership. The bank learned that the dealership was fabricating certificates of ownership of autos and other acts which violated the loan agreement. The bank arranged to have itself replaced on the loan but did not inform the new lender of the wrongful acts of the dealership. Ultimately, the fraud was discovered and the bank was sued for fraudulent concealment. The insurer settled the suit and attempted to collect from the reinsurer based on the doctrine of follow the settlements.

The court acknowledge this doctrine but also its limitations: "(W)hile a reinsurer in most cases must follow the fortunes of the reinsured, a payment by an insurer that is clearly and unambiguously outside the scope of the insurance policy is *ex gratia* and does not bind the reinsurer."[4] In this case, the court ruled that the payment of the claim by the cedent was improper since it involved willful conversion by the dealership and a state statute that declared as against public policy contracts intended to exempt anyone from responsibility for violation of law. Since the claim should not have been paid in the first place, it was *ex gratia* with respect to the reinsurer.

V. Conclusion

The follow the settlements doctrine requires reinsurers to indemnify cedents for claims settled by the cedents which are reasonably within the ambit of the policies in question. Claims which are not reasonably within the ambit are *ex gratia*.

Ex gratia claims may arise in a variety of contexts. For instance, agreements between the insured and insurer over the administration of APH claims may alter the coverage in a fashion that creates a gap between that which was originally insured and reinsured and the claim that was actually paid. In some instances, the insurer might find it necessary to pay some damages which not covered in order to settle an entire claim. Finally, the insurer might pay claims that are clearly improper due to collusion or statutory prohibition. In all of these situations, the cedent should anticipate an *ex gratia* defense by reinsurers.

ENDNOTES

[1] *See e.g.* Robert M. Hall, *Follow the Settlements: Bad Faith Claims Handling Exception,* XIV ARIAS-US Quarterly No. 3 at 24 (2007).
[2] 831 F. Supp. 1132 at 1146.
[3] 447 S.W. 2d 462 at 469 (internal citations omitted).
[4] 197 Mass. Super. Lexis 593*9.