FOLLOW THE SETTLEMENTS:

BAD CLAIMS HANDLING EXCEPTION

By

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I. Introduction

Follow the settlements provisions in reinsurance contracts are intended to prevent reinsurers from second guessing the claim handling decisions of cedents. Such provisions are subject to a number of exceptions, however. The purpose of this article is to explore case law concerning one of these exceptions: bad claim handling by the ceding company.

II. Articulation of the Exception

The exception has been articulated basically in two ways. The first focuses on a "reasonable, business like investigation" of the claim[1] and the second on "gross negligence or recklessness" in handling the claim.[2] The case law in which this exception has been applied provides some insight into the nature and degree of errors necessary to apply the exception to the follow the settlements doctrine. Case law may also provide practical distinctions between the two articulations of the rule.

III. Case Law

A. Cases Denying Exception to the Rule

Aetna Casualty and Surety Co. v. Home Ins. Co., 882 F. Supp. 1328 (S.D.N.Y. 1995) was a dispute in which the cedent, Aetna, issued a series of excess policies to Robins which were impacted by Dalkon Shield litigation. The excess policies did not include a defense obligation but during the course of the litigation, Aetna agreed to provide a defense on covered claims without stating explicitly whether

or not claims expenses would be within limits. Home signed off on this agreement.

Subsequent litigation between Aetna and Robins concerning the claims within limits issue was settled by Aetna in a fashion favorable Robins. Home resisted payment of expenses arguing that claims expenses should be within limits. The court found that Aetna's settlement was reasonable and businesslike and that Home was obligated to follow it:

> [S]ubject to the ceding company's duty of utmost good faith, and the requirement that investigations such as the one conducted by [the Aetna claims examiner] be reasonable and businesslike, the doctrine leaves it to the ceding company to make the settlement decision in the first instance, which settlement is then binding upon the reinsurers. . . . [I]t is the reasonableness of Aetna's interpretation of the scope of coverage at the time of the settlement that is dispositive of the reinsurer's obligations to the reinsured.[3]

American Marine Ins. Group v. Neptunia Ins. Co., 775 F. Supp. 703 (S.D.N.Y. 1991) involved a hull and machinery policy and whether or not the reinsurance contract covered a compromised total loss pursuant to a follow the fortunes clause. On a summary judgment motion, the court found that the contract did cover such a loss and commented on the reinsurer's obligation as follows:

> [C]ompromised total loss was within the scope of the reinsurance policy; for plaintiff to avoid the grant of summary judgment it must show that the settlement was unreasonable and the product of dishonesty or unbusinesslike conduct. Because plaintiff has failed to show that there exist genuine issues of material fact, defendant is entitled to judgment as a matter of law, and its cross-motion for summary judgment is granted.[4]

The reinsurer argued that the cedent was obligated to prove every fact necessary for the insured to recover against the cedent in Ins. Co. of the State of New York v. Associated Manufacturers' Mutual Fire Ins. Corp., 74 N.Y.S. 1038 (S.C. N.Y. App. Div. 1902 aff'd 174 N.Y. 541 (1903). The court found no evidence in the record that the claim was improperly adjusted or paid.

B. Cases Finding Exception to the Rule

American Employers' Ins. Co. v. Swiss Re America Corp., 275 F. Supp.2d 29 (D. Mass. 2003)[5] was a summary judgment action by which the cedent sought a declaration that its settlement with its insured over multiple polluted sites was reasonable and should be covered pursuant to a follow the settlements clause. The underlying policies were multi-year but the facultative certificates were

annual. The insured never argued that limits should be annualized but the cedent, in its settlement value calculations, did so.

Following mediation on 10 sites, the cedent and insured settled with respect to those sites and another 27 sites about which the cedent had no information. $2.8 million of the settlement was allocated to the 27 sites. The court found no basis for annualizing the limits and that the reinsurer was not obligated to follow the settlements with respect to the $2.8 million allocated to the 27 sites:

> The reinsurer's burden is a high one, as it must show not mere negligence, but gross negligence or recklessness. Swiss Re has met it burden here. AEIC's failure to obtain any documentation on the twenty-seven sites to which it allocated $2.8 million of its settlement with [the insured] is wholly inconsistent with its obligation to its reinsurer to settle claims in good faith.[6]

The settlement of pollution claims at 51 sites, bad faith claims and a buyout of 31 policies provided the factual backdrop for Hartford Accident & Indemnity v. Columbia Cas. Co., 98 F. Supp. 2d 251 (D. Conn. 2000). However, the settlement was allocated, for purposes of reinsurance recovery, to one site where the cedent deemed a "sudden and accidental" loss had occurred. The reinsurer argued that this allocation was designed to maximize recovery under the excess of loss reinsurance and there was some evidence in the record to support this. The court denied the cedent's motion for summary judgment:

> While mere negligence would not support a finding of bad faith sufficient to avoid application of the "follow the fortunes" doctrine, the Court is unable to conclude on this disputed record, that Columbia's evidence, if credited, could not support a finding of gross negligence. ("Bad faith requires an extraordinary showing of disingenuous or dishonest failure to carry out a contract. The standard is not mere negligence, but gross negligence or recklessness.") (citation omitted) While Hartford contends that its allocation of the entire settlement to the Newsom Site was completely reasonable, the above facts could support inferences from which a factfinder could conclude that Hartford's conduct manifested gross negligence or recklessness. Such disputes as to the proper inferences to be drawn from these facts and circumstances requires determination by a jury.[7]

Suter v. General Accident Ins. Co. of America, 2006 U.S. Dist. Lexis 48209 (D. N.J.) involved a series of excess insurance policies covering Pfizer which manufactured the Shiley heart valve. A small percentage of these valves fractured after implantation and normal use as a result of a manufacturing defect. Pfizer settled a class action by those injured by the failure of the valve as well as many individuals seeking recovery for anxiety that their valves might fail in the future.

Pfizer used the date of implantation of the valve as the date of loss but several court cases assigned the date of fracture as the date of loss. The cedent, however, adopted Pfizer's point of view which increased the number of covered losses. In addition, the cedent apparently disregarded case law that anxiety about possible future injury is not "bodily injury" covered by general liability policies. The only way in which the cedent's attachment point could have been reached was to include the anxiety claims in the loss. The cedent did not attempt to determine whether underlying limits had been exhausted and the court found that such limits had not been exhausted.

On this record, the court ruled that the reinsurer need not follow the cedent's settlement of the Pfizer claim:

> The application of "follow the settlements" doctrine is subject to the requirement that the reinsured make a reasonable, businesslike investigation. (citation omitted) What is a reasonable, businesslike investigation of course must depend on the facts of each case. The factual findings support the conclusion that [the cedent's] investigation of the Pfizer claim was superficial, relying as it did on Pfizer's position and opinions of Transit's counsel, which were even at times inaccurate. The defendant has demonstrated that [the cedent] did not make the kind of reasonable and businesslike investigation that the circumstances required.[8]

IV. Conclusion

Case law is useful in demonstrating the situations in which this exception to follow the settlements principle may be applied. However, case law to date is not definitive in demonstrating the practical differences between the two ways in which the exception is articulated *i.e.* a "reasonable, business-like investigation" or the absence of "gross negligence or recklessness."

Whichever articulation is used, however, it is likely that this line of cases will add a new element to coverage disputes *i.e.* closer scrutiny of the manner in which claims are investigated and settled by ceding companies. To the extent that case law limits this rule to truly incompetent and/or dishonest claims adjusting and settlement, it should not undercut but place reasonable limits on the cedent's judgment calls which are protected by the follow the settlements doctrine.

ENDNOTES

[1] See Aetna Casualty and Surety Co. v. Home Ins. Co. 882 F. Supp. 1328, 1347 (S.D.N.Y.1995); Suter v. General Accident Ins. Co. 2006 U.S. Dist. Lexis 48209 *73 (D.N.Y.); American Marine Ins. Group v. Neptunia Ins. Co., 775 F. Supp. 703, 708 (S.D.N.Y. 1991); Ins. Co. of State of N.Y. v. Associated Manufacturers' Mutual Ins. Corp., 74 N.Y.S. 1038 (S.C. App. Div. 1902) aff'd 174 N.Y. 541 (1903).

[2] See American Employers' Ins. Co. v. Swiss Reinsurance America Corp., 275 F.Supp. 29, 39 (D. Mass. 2003); Hartford Accident & Indemnity Co. v. Columbia Cas. Co., 98 F.Supp.2d 258, 260 (D. Conn. 2000).

[3] 882 F. Supp. 1328 at 1351.

[4] 775 F. Supp. 703 at 709.

[5] This decision was vacated and remanded on other grounds 413 F.3d 121 (1st Cir. 2005).

[6] 275 F. Supp.2d 29 at 39.

[7] 98 F. Supp. 2d 251 at 260.

[8] 2006 U.S. Dist. Lexis 48209 *84. This decision was appealed but the case was then settled and the appeal dismissed with this decision being vacated. 2007 U.S. Lexis 70406 (D.N.J.)