Settlement and Compromise

Reasonableness of Insurance Allocation Decisions Following Settlement

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Two years ago, in *United States Fidelity & Guaranty Co. v. American Re-Insurance Co.* (*USF&G*), the Court of Appeals confirmed that the "follow the settlements" doctrine in the reinsurance context is robust and applies to an insurance company's allocation decisions following a settlement with its insured. It nevertheless found evidence on the record that the allocation decision at issue may not have been reasonable, and ruled that a trial must be held on that issue. With that case apparently heading to trial, the First Department recently decided a related issue in *New Hampshire Insurance Company v. Clearwater Insurance Company*.[1]

In *New Hampshire*, the Appellate Division, First Department, was faced with the question whether a reinsurer must "follow the settlements" in the absence of a specific agreement to do so. But the court reserved answer on that question for another day because, following *USF&G*, it found questions of fact existed on the issue of whether the allocation at issue was reasonable—even assuming the "follow the fortunes" doctrine applied.

Background and Settlement

New Hampshire Insurance Company, an AIG-affiliated company, issued an excess insurance policy to Kaiser Aluminum & Chemical Corporation in 1973. New Hampshire ceded a portion of this risk to reinsurer Clearwater Insurance Company.[2]

Beginning in the 1970s, Kaiser was named in what ultimately became thousands of asbestos-related personal injury cases. In the early 2000s, Kaiser sued New Hampshire and six other AIG companies (collectively, AIG), along with other non-AIG companies, for coverage for the asbestos-related claims. Kaiser also asserted claims for defense costs, bad faith, and premises liability claims against certain AIG insurers, but not New Hampshire.

During the coverage litigation, Kaiser's liability for personal injury claims was estimated at up to $2.5 billion. It had only $1.5 billion of solvent insurance coverage remaining, of which $568 million was from the AIG carriers' policy limits.

Kaiser and AIG settled for the AIG carriers' aggregate policy limit of $568 million. The settlement itself did not allocate this amount among carriers, policies, or claims. Instead, it allowed AIG to make its own allocation "solely for its own purposes."[3] AIG allocated 100 percent of the settlement amount to product liability claims. It allocated nothing to premises liability claims, bad faith claims, or defense costs, despite the fact that these claims were specifically released in the settlement.

Pursuant to the settlement, payments were to be made on a quarterly basis. AIG allocated these payments using a "horizontal bathtub" methodology: losses were allocated to all policies at the same level of coverage until that level was exhausted, and then to all policies at the next level of coverage, and so on. Thus, an insurer's liability did not kick in until all layers beneath it were exhausted.

The Reinsurance Litigation

When New Hampshire's "layer" became due and it began making payments under the settlement, it demanded payment from Clearwater. Clearwater refused to pay, and this litigation ensued. Clearwater's defenses to New Hampshire's coverage demands included (1) that New Hampshire had failed to meet its notice requirements under the reinsurance agreements; (2) that New Hampshire had breached a retention warranty in the policy; and (3) that the allocation made by AIG was designed to maximize reinsurance coverage. Before any significant discovery had taken place, New Hampshire moved for summary judgment on these defenses.

The Supreme Court, New York County (Coin, J.) granted the motion with respect to all but the allocation issue. With respect to allocation, the Supreme Court first held that Clearwater was estopped from denying that its insurance certificate required it to "follow the settlements" made by New Hampshire, based on the interpretation of similar contract language in a Massachusetts case with another insurer.[4] The court nevertheless denied summary judgment, holding that on the record presented there was a triable question of fact whether the allocation was reasonable.[5]

The Doctrine

The First Department, in a relatively lengthy decision, affirmed the portion of the Supreme Court's decision that denied summary judgment on the allocation issue.[6]

The court first analyzed the question whether Clearwater's certificate required it to "follow the settlements," a doctrine that, "[w]here it applies…'ordinarily bars challenge by a reinsurer to the decision of [the cedent] to settle a case for a particular amount.'"[7] This doctrine generally prohibits a reinsurer from challenging the reasonable, good-faith determinations by the cedent to pay under a policy, even if amounts paid were not technically covered by the policy. Where the doctrine does not apply, a cedent must show that the settlement at issue paid "only for claims that were actually covered by the…policy."[8]

As the court noted, the "follow the settlements" doctrine "'meets the goal of maximizing coverage and settlement and…streamlines the reimbursement process and reduces

litigation.'"[9] And, in the USF&G case, the Court of Appeals recently clarified that, where this doctrine applies, it also applies to allocation decisions.[10]

But the issue here was less clear cut because the reinsurance certificate at issue did not have an express "follow the settlements" clause. Instead, it provided that Clearwater's "liability…shall flow from [New Hampshire's] liability in accordance with the terms and conditions of the policy reinsured hereunder."[11] By contrast, in *USF&G*, the clause at issue stated that "[a]ll claims in which this reinsurance is involved, when allowed by the Company [the cedent, USF&G], shall be binding upon the reinsurers…."[12]

The Supreme Court in *New Hampshire* held that Clearwater was estopped from arguing that this provision was not a "follow the settlements" clause, based on the decision of a Massachusetts trial court holding that this language did require Clearwater to follow the settlements.[13] The First Department disagreed. It noted that collateral estoppel does not apply to "pure questions of law," such as "[t]he interpretation of an unambiguous contract," and it also disagreed with the Massachusetts' court's interpretation of the relevant contract.[14] The First Department instead agreed with Clearwater that the certificate language constituted a "follow the form" clause, which simply makes the reinsurance and insurance contracts "concurrent," or covering the same risks.[15]

The First Department then framed the issue as one that had never been addressed by a New York appellate court—whether, absent an express "follow the settlements" provision, a reinsurer has an implied duty to do so. The court noted that the answer is unsettled among other jurisdictions that have addressed it, but in a footnote suggested that it may side with those jurisdictions that find no implied duty to "follow the settlements."[16]

The court decided it need not join the fray, however: "We need not resolve this question to decide this appeal, since, even if Clearwater is obligated to 'follow the settlements,' the reasonableness of New Hampshire's allocation…cannot be determined as a matter of law on this record."[17] This is because, even where the doctrine applies, a cedent's allocation decisions are not "immune from scrutiny." Instead, an allocation must be "objective[ly] reasonable[]"—namely, one that might have been chosen even in the absence of reinsurance coverage.[18] "[T]he cedent's motive should generally be unimportant."[19]

Reasonableness of Allocation

The court then addressed the issue whether the allocation made by AIG—that is, to allocate 100 percent of the settlement amount to personal injury claims, and none to bad faith or other claims—was reasonable. And in this regard, New Hampshire's decision to move for summary judgment before much discovery had taken place doomed it.

New Hampshire apparently moved for summary judgment at such an early stage because it believed that AIG's "horizontal bathtub" approach was reasonable as a matter of law. It argued that it was "an unassailable approach" that was "reinsurance-blind and reinsurance-neutral," and that "no court has ever accepted a reinsurer challenge to a bathtub allocation."[20]

The Supreme Court rejected this argument, and the First Department agreed, noting that Clearwater did not take issue with the bathtub approach at all, but instead with "'the nature of the claims to which the settlement was allocated.'" Put differently, the First Department adopted Clearwater's statement of the issue: "[T]he question is not what methodology AIG uses to fill its bathtub, but, rather, what AIG is pouring into its bathtub as an initial matter."[21]

As framed by Clearwater—and accepted by the court—the question was not how the loss was allocated among the different insurers and policies, but whether it was reasonable for AIG to allocate none of the settlement to claims that were released but may not have been covered by reinsurance. The court explained that "[i]t may be that the allocation could be justified on the ground that the claims given no allocation were highly unlikely to prevail, or so small in value relative to the asbestos products claims as to be immaterial, but we simply have no basis to make such a determination on this record."[22]

Citing the "undeveloped record," the court pointed out that New Hampshire had submitted no affidavit proof about the reasonableness of its allocation, but that even if it had, "Clearwater had not had an adequate opportunity to explore the justification of the allocation through discovery."[23]

This issue was therefore remanded, and New Hampshire will have to produce discovery regarding the reasonableness of AIG's allocation. And because the issue is unresolved as to whether Clearwater is bound to "follow the settlement," it seems New Hampshire will need to develop a record that the settlement amounts to be paid by it would actually have been covered by its policy, and hence covered by the reinsurance policy.

Practice Tips

A couple of lessons can be learned from this case. First, although New York courts endorse a robust "follow the settlements" doctrine, including as to allocation decisions, it is not clear that it applies in every reinsurance case, such as those lacking an express "follow the settlements" clause. The First Department expressly reserved this question "to be resolved in future proceedings."[24] And second, although New York courts require deference to a cedent's allocation decisions where the doctrine applies, it seems that substantial litigation and discovery will need to take place in many, if not all cases, before a court will determine whether that allocation was objectively reasonable.

Given that *New Hampshire* was decided without the benefit of a fully developed record, it is unclear whether a cedent's decision not to allocate any of a settlement to non-covered claims will always create a jury question as to reasonableness (as it did in *USF&G*) or whether, in most cases, a cedent will be able to show that its allocation was objectively reasonable. Even though the standard is supposed to be one of "objective reasonableness," these recent cases suggest that insurance companies would be wise to remember that their subjective rationales for their allocation decisions will likely be scrutinized in coverage disputes with reinsurers.

Endnotes:

1. 2015 WL 1292579 (1st Dept. March 24, 2015).

2. In reinsurance parlance, New Hampshire is referred to as the "cedent."

3. Id. at *4.

4. Id. at *6.

5. Id. at *6.

6. The court also reversed the Supreme Court's grant of summary judgment on the late notice and warranty defenses. Id. at *9.

7. Id. at *5 (quoting *U.S. Fid. & Guar. Co. v. Am. Re-Ins. Co.*, 20 N.Y.3d 407, 418 (2013) (*USF&G*).

8. Id. at *9.

9. Id. (quoting *Travelers Cas. & Sur. Co. v. Certain Underwriters at Lloyd's of London*, 96 N.Y.2d 583, 596 (2001)).

10. *USF&G*, 20 N.Y.3d at 419.

11. *New Hampshire*, 2015 WL 1292579, at *2.

12. *USF&G*, 20 N.Y.3d at 418.

13. *New Hampshire*, 2015 WL 1292579, at *6 (citing *Lexington Ins. Co. v. Clearwater Ins. Co.*, 28 Mass. L. Rptr. 519 (Mass. Super. 2011)).

14. Id. at *6-*7.

15. Id. at *7.

16. Id. at *8 n.7 ("We note that certain scholars in the field have argued that, in the absence of a contractual provision expressly incorporating it, the 'follow the settlements' doctrine should not be implied in a contract of reinsurance." (citing authorities)).

17. Id. at *8.

18. Id. at *8 (citing *USF&G*, 20 N.Y.3d at 420).

19. *USF&G*, 20 N.Y.3d at 421.

20. Brief for Plaintiff-Appellant-Respondent, *New Hampshire Ins. Co. v. Clearwater Ins. Co.*, No. 12779, 2014 WL 4493291, at *15 (1st Dept. filed Jan. 27, 2014).

21. *New Hampshire*, 2015 WL 1292579, at *9. The court also pointed out that the cases New Hampshire relied on had been decided on "fully developed evidentiary records and, in some cases, after trial." Id. at *8 n.9.

22. Id. at *8.

23. Id.

24. Id. at 9.

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