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USF&G v. American Re:

The Latest Word on The Follow the Fortunes Doctrine from U.S. Courts

Because the majority of reinsurance contracts contain arbitration provisions, reported reinsurance decisions from influential courts are relatively rare. On February 7, 2013, however, the New York Court of Appeals issued its decision in the case of *United States Fidelity & Guaranty Co. v. American Re-Insurance Co.*, 20 N.Y.3d 407, 985 N.E.2d 876 (N.Y. 2013). This decision may prove to be one of the most significant reinsurance precedents in recent years.

I. BACKGROUND FACTS

The reinsurance dispute arose out of lengthy coverage litigation between United States Fidelity & Guaranty Company ("USF&G") and Western MacArthur Company ("Western MacArthur"). In the 1980s, individuals claiming bodily injuries on account of exposure to the asbestos products distributed by Western MacArthur's predecessor, Western Asbestos, began to sue Western MacArthur. Western MacArthur alleged that USF&G had insured Western Asbestos and it tendered its defense to USF&G. USF&G refused to accept the defense, denying that it had insured Western Asbestos. In 1993, Western MacArthur sued USF&G for coverage in California state court. The coverage litigation would last for almost nine years.

During the coverage litigation, Western MacArthur uncovered significant additional secondary evidence that USF&G had, in fact, insured Western Asbestos. This evidence included copies of over 100 cancelled checks from USF&G to pay claims asserted against Western Asbestos and claim registries that USF&G had "donated" to an obscure Baltimore museum showing that USF&G had insured Western Asbestos. Despite this growing mound of evidence, USF&G still maintained that it had never insured Western Asbestos.

Trial in the coverage case commenced in early 2002. During the trial, a USF&G witness conceded on cross-examination that USF&G had known for years that it had insured Western Asbestos. Almost immediately after this testimony, USF&G finally admitted that it had issued multiple policies to Western Asbestos and it settled for almost $1 billion.

In November 2002, USF&G presented reinsurance billings to its reinsurers in the amount of approximately $400 million. In its billings, USF&G insisted that it had not paid anything on account of its exposure to Western MacArthur's bad faith claims.

A. Lower Court Proceedings

Less than two weeks after presenting its initial billing to reinsurers, USF&G sued them. During the reinsurance litigation, USF&G argued that the follow-the-fortunes doctrine precluded the reinsurers from challenging the assumptions that USF&G relied upon when preparing its reinsurance billings, including USF&G's decision not to attribute any portion of its settlement to

Western MacArthur's bad faith claims. In 2010, the trial court granted summary judgment in USF&G's favor on that basis.

In 2012, the New York intermediate court of review (the Supreme Court, Appellate Division) affirmed. *United States Fidelity & Guaranty Co. v. American Re-Insurance Co.*, 93 A.D. 14, 939 N.Y.S. 2d 307 (App. Div. 2012). In its decision, the Appellate Decision broadly interpreted the follow-the-fortunes doctrine to "preclude from this court's review" any and all challenges to the decisions that USF&G made in connection with the reinsurance billing. *Id.*, 93 A.D. 3d at 23-24. This included USF&G's assertion that no portion of the settlement payment was attributable to Western MacArthur's bad faith claims. Thus, the Appellate Division interpreted the follow-the-fortunes doctrine so broadly that, not only were the cedent's actions vis-à-vis its policyholder unquestionable, but the cedent's later-in-time decisions regarding its preparation of the reinsurance billing were also beyond all meaningful scrutiny.

B. Court of Appeals Decision

On February 7, 2013, New York's highest court issued an opinion that rejected the Appellate Division's broad interpretation of the follow-the-fortunes doctrine. *United States Fidelity & Guaranty Co. v. American Re-Insurance Co.*, 20 N.Y.3d 407, 985 N.E.2d 876 (N.Y. 2013). The Court of Appeals initially agreed that the follow-the-fortunes doctrine requires deference to a cedent's post-settlement allocation decisions. *Id.* at 419. Parting company with the Appellate Division, however, the Court of Appeals noted that "to say that a cedent's allocation decisions are entitled to deference is not to say that they are immune from scrutiny." *Id.* at 420. Reinforcing long-established reinsurance principles, the court noted that a reinsurer is bound by a cedent's decisions only if they are reasonable and made in good faith. *Id*.

Significantly, the court ruled that a cedent's subjective assertion that its decisions were reasonable and in good faith are insufficient to establish that they are. *Id.* As the court held, "objective reasonableness should ordinary determine the validity" of the assumptions supporting a reinsurance billing. *Id.* The cedent's "allocation must be one that the parties to the settlement of the underlying insurance claim might reasonably have arrived at in arms-length negotiations if the reinsurance did not exist." *Id.*

USF&G argued that the reasonableness of its allocation decisions was established by the fact that those decisions were allegedly consistent with its settlement negotiations with Western MacArthur and the asbestos claimants. The Court of Appeals, however, held that "reasonableness cannot be established merely by showing that the cedent's allocation for reinsurance purposes is the same as the allocation that the cedent and the insurance claimants actually adopted in settling the underlying insurance claims." *Id.* at 421. As the Court of Appeals stated:

> [W]e are reluctant to adopt a rule whereby an insurer could insulate its allocation from challenge by its reinsurer simply by getting its, essentially indifferent, insured to agree to it. Indeed, we will put the point more strongly … : in many cases claimants and insured (*i.e.*, those in the position of the asbestos claimants and MacArthur here), far from being indifferent, will enthusiastically

> support insurers' efforts to fund a settlement at reinsurers' expense. They will do this for the simple reason that insurers, like everyone else, are apt to be more generous with other people's money than their own.
>
> In sum, under a follow the settlements 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.

Id. (internal citations and quotations omitted).

Having established those parameters around the follow-the-fortunes doctrine, the court proceeded to apply those parameters to the facts of the case. Addressing USF&G's decision to attribute no value to Western MacArthur's bad faith claims, the Court of Appeals concluded that a fact finder could have reasonably found that USF&G's decision to give no value to its unreinsured bad faith exposure was unreasonable. *Id.* at 422. Thus, the Court of Appeals reversed the summary judgment in favor of USF&G and remanded the case for further proceedings as to the reasonableness of the assumptions underlying USF&G's reinsurance billing.

II. CONCLUSION

Although there are many aspects of the *USF&G* decision that are significant for the reinsurance industry, perhaps the most significant is the fact that the Court of Appeals rejected the lower appellate court's holding that the follow-the-fortunes doctrine placed virtually all aspects of the ceding company's post-settlement decisions beyond judicial review. Instead, the Court of Appeals reaffirmed long-standing principles that, even under the follow-the-fortunes doctrine, reinsurers are entitled to challenge reinsurance billings that do not appear to be reasonable or to have been made in good faith.