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## **NY Cedents Enjoy More Protection And Authority**

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After the New York Court of Appeals issued its decision in *United States Fidelity & Guaranty Co. v. American Re-Insurance Co.* (N.Y. Feb. 7, 2013), some commentators have characterized the decision as one favorable to reinsurers. However, the Court of Appeals actually provides further support for expanding the protections of the “follow-the-settlement” doctrine to post-settlement allocation decisions.

In addition, the court rejected the reinsurers’ defenses based on the fact that the cedent’s actions allowed it to access additional reinsurance than could have been accessed if the claims had been settled on different terms. Ultimately, the decision gives cedents additional ammunition to combat recalcitrant reinsurers’ attempts to second-guess the cedents’ settlement and allocation decisions.

### **Background**

The reinsurers argued that the follow-the-settlement doctrine did not bind them to USF&G’s (their cedent’s) decisions about how to bill to the reinsurers the amounts USF&G paid to settle the coverage litigation, i.e., USF&G’s post-settlement allocation decisions.

In particular, the reinsurers claimed that the doctrine did not bind them to USF&G’s decisions about which USF&G policies were triggered by the underlying asbestos claims; the amount USF&G paid to settle its insured’s bad faith claim; and the monetary value of the underlying claims.

### **The New York Court of Appeals’ Ruling**

Following decisions from the U.S. Court of Appeals for the Second Circuit and the U.S. Court of Appeals for the Third Circuit, the New York Court of Appeals rejected the reinsurers’ position. The court held that the follow-the-settlement doctrine applied to a cedent’s post-settlement allocation decisions. The court recognized that reviewing each allocation decision anew “would invite long litigation over complex issues that courts may not be well equipped to resolve, creating cost and uncertainty and making the reinsurance market less efficient.”

On the other hand, giving cedents’ post-settlement allocation decisions the same deference as cedents’ settlement decisions “makes for a more orderly and predictable resolution of claims,” the court explained. Thus, the court held that a cedent’s reasonable allocation decision binds its reinsurers.

To determine whether an allocation decision was reasonable, the court considered whether the decision was “one that the parties to the settlement of the underlying insurance claims might reasonably have arrived at in arm’s length negotiations if the reinsurance did not exist.”

To evaluate the cedent's allocation decision, the court enunciated three important guidelines. First, "[c]edents are not fiduciaries of reinsurers, and are not required to put the interests of reinsurers ahead of their own." Second, the court rejected a statement in a Third Circuit decision that an allocation "motivated primarily by reinsurance considerations" could be challenged; instead, it concluded that "the cedent's motive should generally be unimportant." Third, it stated that when faced with multiple reasonable allocations, the cedent may properly choose the allocation most favorable to it, based on the cedent's own interests.

Applying these principles, the court considered the reinsurers' challenge to USF&G's decision to allocate all losses to one policy rather than prorating the losses over the many policy years in which the underlying claimants were exposed to asbestos. If USF&G had allocated the losses over the multiple policy years, it was likely that very few, if any, claims would exceed USF&G's retention under the reinsurance agreements.

Such an allocation would likely deprive USF&G of any substantial reinsurance recovery. On the other hand, if the losses were allocated to one policy, USF&G could access significantly more reinsurance. Notwithstanding this difference in the ability to recover under reinsurance agreements, the court rejected the reinsurers' challenge. It found that USF&G's decision to allocate all losses to one policy was reasonable, based on the governing law at the time of settlement.

Accordingly, the court affirmed summary judgment in favor of USF&G on this issue, even though the decision to allocate to one policy period allowed it to access additional reinsurance, while other allocations may have entirely deprived USF&G of reinsurance recoveries.

With respect to two other allocation decisions, the court remanded the case to the trial court to resolve factual issues. First, with respect to USF&G's decision to allocate no value to the insured's bad faith claims, the court cited evidence that would allow a fact-finder to conclude that the decision was unreasonable.

This evidence included that there was a significant risk of an adverse bad faith verdict against USF&G, given that it could have been found that USF&G had denied for years that it provided any coverage to its insured, even though it knew it actually did provide coverage; that USF&G inflated values to certain types of asbestos claims instead of giving any value to the bad faith claims; that USF&G and its insured persuaded a bankruptcy court to approve their settlement partly on the ground that the bad faith claims had significant value; and that the insured's settlement demand to USF&G made just seven weeks before the parties settled included a demand of more than \$150 million to settle the bad faith claim.

The court did not conclude that USF&G's actions were improper but instead only found that the trial court should not have granted summary judgment, given the various factual issues.

Second, the court concluded that a fact-finder could determine that USF&G's decision to value lung cancer claims at \$200,000 was unreasonable. In support of that conclusion, the court cited the asbestos claimants' expert's estimation in the coverage litigation that the insured's liability for each lung cancer claim was under \$100,000, as well as the lack of any allocation of the settlement amount to the bad faith claims.

Even ignoring the lack of any allocation to the bad faith claims, the court suggested that one possible inference was that claims based on other injuries, such as asbestosis, pleural thickening

and “other cancer,” which had values of \$50,000, \$20,000 and \$20,000, respectively, were undervalued.

Accordingly, for these two allocation decisions, the court found factual issues regarding whether the decisions were ones “that the parties to the settlement of the underlying insurance claims might reasonably have arrived at in arm’s length negotiations if the reinsurance did not exist.”

The proceedings in the trial court will determine if USF&G’s actions as to these decisions provide a basis for the reinsurers to not pay amounts they otherwise would owe.

## **Implications**

The USF&G decision is significant because the New York Court of Appeals specifically held that the follow-the-settlement doctrine protects cedent’s post-settlement allocation decisions. Thus, cedents may use the decision to further undermine reinsurers’ arguments that allocation decisions are not accorded the same deference as settlement decisions. That is, the decision provides additional support that reasonable allocation decisions bind reinsurers just like reasonable settlement decisions bind reinsurers.

The Court of Appeals also provided a standard for evaluating the reasonableness of cedent’s post-settlement allocation decisions — whether an allocation decision is one that the cedent and insured may have reasonably arrived at in arm’s-length negotiations if the reinsurance did not exist. Cedents and reinsurers alike may use this standard to support their respective positions, but the court’s decision makes clear that the standard cannot be used to negate the deference given to allocation decisions.

Indeed, the court rejected one of the reinsurers’ primary grounds for challenging settlement and allocation decisions — that the cedent was motivated to settle or allocate in a particular way because of reinsurance. The court concluded that cedents were not fiduciaries of the reinsurers.

And more specifically, the court observed that “[r]easonableness does not imply disregard of a cedent’s own interests,” that cedents “are not required to put the interests of reinsurers ahead of their own,” that “the cedent’s motive should generally be unimportant” and that the cedent may choose the allocation most favorable to itself. Cedents should be able to rely on the decision effectively against reinsurers that contest settlement or allocation decisions merely because those decisions increased the cedents’ reinsurance recoveries.

In sum, the Court of Appeals’ decision provides additional authority to cedents seeking to recover reinsurance billings from recalcitrant reinsurers. Consistent with case law from several other courts, the ruling reaffirms that the follow-the-settlement doctrine also protects cedents’ post-settlement decisions about allocating settlement amounts to their reinsurers.

Moreover, in determining whether an allocation decision is reasonable, the USF&G court recognized that a cedent is not required to put its reinsurers’ interests ahead of its own and that a cedent may properly choose the allocation that is most favorable to itself, including one that increases its access to reinsurance recoveries.

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