



How Far Can Follow-the-Settlements Go Without Factual Inquiry?

New York Court of Appeals Finds Reasonableness of Allocation Presents Questions of Fact

By: [Mark Deptula](#) and [John F. Kloecker](#)

Recently, the New York Court of Appeals, finding that questions of fact existed as to whether a cedent's allocation was done to maximize reinsurance recovery, partially reversed summary judgment in favor of United States Fid. & Guaranty Co. ("USF&G") for claims arising out of its long running insurance battle over MacArthur's asbestos liabilities. [Click here](#) to view the February 7, 2013, opinion. While the Court recognized that the "follow-the-settlements" doctrine applied to post-settlement allocation, the Court stated that "[t]he reinsured's allocation must be 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." The Court also held that allocation issues relating to USF&G's bad faith and inflation of claim values created issues of fact and therefore must be determined at trial.

The Dispute And Court's Holding

In 2002, USF&G settled its California state court insurance coverage action regarding MacArthur's asbestos liabilities. USF&G then turned to its reinsurers and sought to recover nearly \$400 million under its 1956 to 1962 excess of loss reinsurance treaties. The reinsurers challenged USF&G's allocation of the settlement payment primarily on the grounds that USF&G did not allocate any of the settlement amount to the bad faith claims asserted against USF&G and that USF&G inflated values for lung cancer claims. The reinsurers argued that by doing so, USF&G unreasonably maximized the allocation to reinsurers while minimizing the impact to USF&G. The New York state trial court granted summary judgment to USF&G and the Appellate Division affirmed.

In partially reversing summary judgment, the New York Court of Appeals noted that the reinsurance treaties included a "follow the settlements" provision which "ordinarily bars" a reinsurer's challenge to the cedent's decision to settle a case for a particular amount. Although a cedent is also entitled to deference regarding allocation of settlements, the Court noted this "is not to say that they are immune from scrutiny" and "objective reasonableness" should ordinarily determine the validity of an allocation. A cedent's allocation of settlement for reinsurance purposes will be binding on a reinsurer if, but only if, it is a reasonable allocation. The Court went on to hold that consistency with the allocation used in settling the underlying claim does not by itself establish reasonableness.



The Court found questions of fact related to whether USF&G's allocation was reasonable. First, a question of fact existed with respect to USF&G's decision to allocate all of the settlement to claims within the policy limits and allocate nothing to the claims of bad faith asserted against USF&G. The Court noted that there was evidence in the record from which a fact finder could conclude that an allocation giving no value to the bad faith claims was unreasonable. Second, there was evidence from which it could be found that USF&G, in allocating the settlement, assigned unreasonably inflated values to lung cancer claims. However, the Court did not find merit in every challenge to the allocation. For example, the Court rejected the reinsurer's challenge to USF&G's allocation of all losses under the settlement to the 1959 policy since it was reasonable to assume that California law allowed an asbestos claimant to choose the 1959 year as there was no policy with higher limits.

Commentary

The USF&G opinion is of significance for cedents and reinsurers in the ongoing debate over the extent to which follow-the-settlements precludes factual inquiry into the underlying settlement and the post-settlement allocation. For reinsurers, while the Court stopped short of ignoring follow-the-settlements as applied to post-settlement allocation, the Court adopted a standard which requires a determination that an allocation is "reasonable" from an objective standpoint and that discounts the insurer's motivation, good or bad, in making the allocation decision. The Court's ruling provides reinsurers with additional precedent to challenge a cedent's allocation decisions. Cedents that rely on an expansive interpretation of the follow-the-settlements doctrine to immunize allocation decisions from scrutiny will face more aggressive challenges from reinsurers based on the ruling. For cedents, the USF&G opinion recognized general follow-the-settlements principles and rejected certain of the reinsurers' challenges leaving room to argue for less factual inquiry into the allocation and that the opinion in USF&G should be limited to its facts.

For additional information, below is the link to the video webcast of the January 2, 2013 oral argument before the New York Court of Appeals:

<http://www.nycourts.gov/ctapps/arguments/2013/Jan13/010213-No1-OralArgument.aspx>

For more information on the matters discussed in this *Locke Lord QuickStudy*, please contact one of the authors:

Mark Deptula | 312-443-1728 | mdeptula@lockelord.com

John F. Kloecker | 312-443-0235 | jkloecker@lockelord.com