THIRD CIRCUIT APPLIES FOLLOW-THE-FORTUNES DOCTRINE TO POST-SETTLEMENT LOSS ALLOCATIONS

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The follow-the-fortunes doctrine is intended to promote the prompt and efficient processing of reinsurance claims and avoid inconsistent coverage decisions at the primary and reinsurance levels. In *Travelers Casualty and Surety Co. v. Insurance Co. of North America*, 2010 WL 2293208 (3d Cir. June 9, 2010) the Third Circuit Court of Appeal applied the doctrine to the post-settlement allocation by an insurer of the amount that it paid its insured to a three layer insurance program.

I. Factual Background

Travelers Casualty and Surety provided insurance for losses relating to two distinct types of risks: breast implants and chemical products. The insurance program was structured in three layers.

- First layer - The polices in this layer provided primary coverage from April 1976 to April 1987 for non-product claims and product claims from outside the United States. All policies in this layer had pre-occurrence limits, but only those issued between April 1985 and 1987 had aggregate coverage limits. This layer was reinsured with a captive owned by the insured, with retrospective premiums due from the insured to Travelers. Policies for April 1976 through April 1982 had a limit on the amount of retrospective premium that might be owed, but post-April 1982 policies had no such limit. With one exception, each policy in this layer was reinsured for 95% of losses above the loss limit, with the remaining policy reinsured for 95.5% of such losses.

- Second layer - The policies in this layer provided excess coverage for U.S. products liability risks from April 1976 to April 1982, above a primary layer of coverage written by a captive of the insured. These policies were reinsured through a captive: 100% reinsured for bodily injury claims from April 1976 - April 1978; and 95% reinsured for all claims from April 1978 - April 1982.

- Third (excess) layer - The policies in this layer covered both products and non-products claims, and were in excess of the first and second layers and all underlying coverage. These policies were reinsured with companies that were unaffiliated with the insured. INA reinsured nine policies in this layer through follow-the-form facultative reinsurance certificates, all of which included a follow-the-fortunes provision. Some policies in this layer provided coverage for three years, with a per-occurrence loss limit.

The courts found that this structure effectively made the insured responsible for "the vast bulk" of the losses ceded to the first two layers of the insurance program. Some of the insurance policies contained occurrence or aggregate loss limits, but others did not.

After Travelers reached a $137 million settlement with its insured, it allocated the settlement amount to the three layers of insurance, and within each layer to the policies in each layer. INA challenged the post-settlement allocation of the settlement amount, and refused to pay the amount billed to it. Travelers sued INA, alleging breach of contract, and contended that the follow-the-fortunes doctrine barred INA from challenging its resolution of the claims. INA did not dispute the propriety of the settlement, but did dispute the post-settlement allocation of the settlement amount. The District Court found that the follow-the-fortunes doctrine applied, that no exceptions to the application of the doctrine applied, and that the reinsurer therefore was bound by the allocation decisions as between the program layers. However, the District Court found that Travelers had misallocated losses within policies in the excess layer. The Court of Appeals affirmed.

II. The District Court's Decision

The District Court denied motions for summary judgment, finding that there was enough evidence "to arouse suspicion" that Travelers had engineered its post-settlement allocation to maximize its reinsurance recovery. The court held a two phase trial: Phase 1 focused on whether Travelers improperly manipulated the allocation of the settlement amount to maximize its reinsurance recoveries; Phase 2 focused on the reasonableness of the allocation of losses among policies in the excess layer of the program given the limits and other terms of those policies. After a trial, which included expert testimony, the court concluded that Travelers had not allocated the settlement amount to maximize its potential reinsurance recovery from INA, and that Traveler's decisions had been made in a businesslike manner and in good faith. The court held, however, that Travelers had misinterpreted the per-occurrence limits of the various excess level policies, allocating too much of the losses to certain policies reinsured by INA. The reallocation of the losses in the excess layer resulted in a lower amount of liability for INA.

III. The Third Circuit's Decision: The Applicability of the Follow-the-Fortunes Doctrine to the Allocation of a Settlement Amount Among Insurance Program Layers.

Noting that there was a dispute as to whether the follow-the-fortunes doctrine applied to post-settlement allocations that were not the product of active bargaining between the insurer and the insured, the court found that the doctrine did apply to post-settlement allocations. It has long been held that one of the principal exceptions to the application of the follow-the-fortunes doctrine arises when the insured has acted in bad faith in its claims resolution process. Travelers conceded that taking reinsurance implications into account in making coverage decisions would have been a breach of its duty of good faith. The court held that the doctrine would not apply if Travelers had made allocation decisions primarily for the purpose of increasing its reinsurance recovery, but that Travelers was not under a duty to act to minimize its reinsurance recovery. The court found that INA had the burden of persuasion to prove that Travelers breached its duty of good faith in making the allocation decisions, and that the fact that the allocations increased Traveler's access to reinsurance was not sufficient proof where Travelers was able to point to non-reinsurance-related reasons for the allocation decisions. To prevail, INA had to prove that Travelers' allocation decisions were motivated primarily by reinsurance considerations.

One interesting aspect of this analysis was the treatment of an internal Travelers memorandum which analyzed some of the coverage issues and their reinsurance implications. The courts accepted Traveler's explanation that the memorandum was a normal business assessment of the potential net exposure to breast implant claims, which was needed to conduct the settlement negotiations with its insured, and that most of its employees dealing with coverage issues never saw the memorandum and were "walled off" from reinsurance analyses. This isolation is good practical advice for insurers dealing with similar issues.

The majority of the appellate opinion consists of a detailed review of the evidence, including the terms and conditions of the policies, the structure of the insurance and reinsurance program, the impact of the captive reinsurance with retrospective premium agreements, advice of outside counsel, the internal memorandum analyzing the reinsurance implications of various alternatives and expert opinion regarding the custom and practice of the industry. Based upon a detailed evaluation of all relevant evidence, the court concluded that Traveler's decisions in allocating the settlement amount between the layers of insurance were reasonable and plausible given the structure of the insurance program and the terms of the various policies, and were not motivated primarily to maximize its reinsurance recovery. Therefore, the follow-the-fortunes doctrine applied to the allocation of the settlement amount among the three insurance layers.

IV. The Third Circuit's Decision: The Allocation of the Losses Among the Excess Layer Policies.

The District Court's Phase 2 decision was based upon its interpretation of the applicable policies, and the Court of Appeals concurred in the result of that decision. It involved a fairly traditional contract interpretation analysis, which was complicated by the number of policies in play, the different provisions of different policies and differing interpretations of applicable law. The principal issue arose because some of the excess layer policies provided coverage for three years, with a single per-occurrence loss limit. Travelers "annualized" the loss limit, resulting in a separate limit for each year of coverage. "[T]he question of whether INA is bound by Travelers' decision to annualize the per-occurrence limits of three-year policies hinges entirely on whether the decision was a reasonable interpretation of how the underlying policies' per-occurrence limits operated." The court accepted INA's interpretation that these policies contained a single loss limit, which applied for the entire three year coverage period of the policies, and that Travelers' decision had improperly enlarged the limits of those policies. The court essentially found that Travelers' interpretation was not even "arguably authorized by the underlying policies," resulting in the follow-the-fortunes doctrine not applying to Travelers' resolution of this issue. This change in the interpretation of the occurrence limit changed the allocation of losses among the policies in the excess layer, resulting in a greater proportion of the losses being allocated to policies not reinsured by INA, thus lowering the amount of INA's reinsurance liability.

V. Conclusion

This opinion contains an interesting application of the follow-the-fortunes doctrine in a somewhat unexpected scenario: post-settlement loss allocation. One may also glean from the opinion advice as to how an insured should go about making such allocations so as to avoid or minimize the exposure to objections from reinsurers.

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