The Continuing Evolution of the Follow-the-Settlements Doctrine in the U.S.

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The follow-the-settlements doctrine addresses the effect of a claim settlement made by a ceding company with its insured on its reinsurer. The doctrine remains at the vital center of reinsurance claims handling, and its meaning and effect is implicated in many disputes. And as a living doctrine, it continues to evolve as new issues are presented and courts render new decisions.

When Does the Doctrine Apply?

Some recent cases have focused on the threshold question of whether the doctrine applies to a given dispute at all. The inconsistent results of these cases demonstrate that if the parties expect the doctrine to apply, they should include an express follow-the-settlements provision in the reinsurance contract. If they do not, then before even reaching the merits, parties can find themselves in prolonged and expensive preliminary motion practice about whether a follow-the-settlements obligation can be constructed from other provisions in the contract, whether one can be implied into the contract as a matter of industry custom and practice, and what burdens of proof apply. This motion practice most often includes a battle of expert witnesses, opining on contract interpretation or industry custom and practice, which adds an increased level of expense and unpredictability to dispute resolution.

In *Employers Re v. Mass Mutual*, 2008 WL 3890358 (U.S.D.C., W.D. Mo.), Employers Re reinsured Connecticut Mutual Life Insurance Company, which merged into Mass Mutual Life Insurance Company, under an Excess Disability Income Treaty. Questions arose about claims handling, and the parties entered into a series of claims control agreements. Following review, Employers Re objected to 12 claims, and then filed suit for alleged breach of contract based on mishandling those claims.

Both sides sought summary judgment on the issue of whether the follow-the-settlements doctrine applied at all. There was no express follow-the-settlements provision in the treaty. But the court in Missouri, applying Connecticut law, found that the treaty contained a follow-the-settlements provision "within the four corners of the agreement." The court constructed one out of the following factors: (1) there was a provision requiring Mass Mutual to investigate, settle, pay or defend claims; (2) there was a provision requiring Employers Re to indemnify Mass Mutual for losses; (3) nowhere in the Treaty did it state that Employers Re could question claims once losses were incurred and paid; (4) Employers Re was the drafter of the Treaty, but did not expressly provide that the doctrine did not apply; (5) if there were any ambiguity, the "course of conduct" clarified it, because Employers Re paid claims for 13 years before objecting. To this court, that meant that Employers Re had "followed the settlements" in the past.

A court in California, however, came to a different result in *American Motorists v. American Re*, 2007 WL 1557848 (U.S.D.C., N.D. Cal.). Although the court noted that other cases in California had construed certain language to constitute a follow-the-settlements provision (even though the contracts in those cases did not use those precise words), none of those formulations appeared in the contract at issue in this case. Here, the court found that a follow-the-settlements obligation could not be constructed from these three provisions: (1) a provision saying the reinsurance follows the terms of the policy; (2) a provision giving the reinsured the right to settle claims; and (3) a provision requiring the reinsurer to indemnify the reinsured.

If the doctrine does not apply, what is the effect? That, too, can vary from jurisdiction to jurisdiction. But in a follow-up to *American Motorists v. American Re*, 2007 WL 4197427 (U.S.D.C., N.D. Cal.), the California court developed one rule. Both parties moved for summary judgment, and both motions were denied. The court found that even though the certificate required the reinsured to defend claims to a "final determination," that did not require litigating a case through judgment. But in the absence of a follow-the-settlements obligation, it would not be sufficient for the reinsured to show simply that the claim had been settled without bad faith. Rather, at trial, the reinsured would have the burden of proving that the claim was actually covered by its policy (as opposed to "arguably covered").

Do the Exceptions Apply?

The general rule is that a cedent's settlement is binding on its reinsurer, but this is subject to several exceptions. The first exception requires that the settlement be made in good faith, after a reasonable and businesslike investigation. (This is sometimes referred as to the bad faith exception.) Next, the settlement must be on a claim arguably encompassed within the scope of the underlying insurance policy. Next, the claim must actually be encompassed within the terms, conditions and limits of the reinsurance contract. Finally, the payment cannot be *ex gratia*.

The *ex gratia* exception is sometimes conflated with either the bad faith exception or the exception relating to claims not arguably encompassed within the underlying policy, but it is actually distinct. *Granite State Ins. Co. v. ACE American Reinsurance Company*, 849 N.YS.2d 201 (1st Dep't 2007) illustrates this point. The AIG Group issued seven excess umbrella liability policies to Castle & Cooke, which subsequently became Dole Foods. Tens of thousands of workers in Central America and the Philippines sued Dole Foods for injuries allegedly suffered as a result of exposure to pesticides. One of the policies, written by an AIG company called Granite State, was facultatively reinsured by ACE American. AIG initially disclaimed coverage on the Granite State policy, relying on an exclusion. It entered into a future cost agreement (FCA) for defense and indemnity in connection with other policies. The FCA did not mention the Granite State policy.

AIG later realized it had paid amounts beyond the available limits on one of the policies. It charged the overpayments to the Granite State policy and amended the FCA. ACE American moved for summary judgment but was unsuccessful. The court recognized that the bad faith exception and the *ex gratia* exception were distinct. But it found questions of fact that precluded summary judgment and required further proceedings. First, there were questions about how the mistake in calculation occurred, which policy the payments should be allocated to, and the reversal of the coverage position from the initial disclaimer. All of these went to bad faith. Next, there was a question of whether by its silence, the original FCA affirmatively excluded the Granite State policy, thereby rendering any further payments *ex gratia*.

Special Issues in Torts-for-Import Cases

The *Granite State* case is notable not only for its exposition of the follow-the-settlements doctrine, but also for its broader background, which is especially relevant to claims arising outside of the U.S. This is because recent years have seen the emergence of the Torts-for-Import business, empowered by the combination of aggressive U.S. trial lawyers and local officials and judges in other countries with weak judicial systems or cultures with a tolerance for corruption.

U.S. trial lawyers find plaintiffs in other countries to assert claims in U.S. courts. Evidence from faraway lands can be hard to gather -- and harder still to refute. At times, "evidence" is simply manufactured, with complicity from local officials. For example, the *Granite State* case arose from underlying claims of plaintiffs who alleged they became sterile after exposure to pesticides when working in Dole Foods' banana fields. They received some favorable judgments against Dole Foods in Nicaragua. But when related cases were heard in the U.S., the real evidence proved that most of the plaintiffs never even worked in Dole's fields, nor were they in fact sterile. In early 2009, a U.S. judge dismissed the cases as a "fraud on the court" and a "blatant extortion." She scolded the plaintiffs' lawyers, and having heard evidence suggesting they had conspired with corrupt Nicaraguan judges and local officials, she asked federal prosecutors to investigate.

Plaintiffs can have greater success if the claim is adjusted or litigated in countries where the rule of law is weak, and manufactured evidence is more readily accepted. As a rough guide to high-risk countries, claims handlers can look to political risk indices in common use in the insurance industry, or to rule-of-law indices prepared by human rights groups.

Large-scale cases are fiercely defended, but there is also cause for caution in other, less notorious international claims. Most basically, there can be questions about the bona fides of the settlements. Claims adjusters or company executives can be placed under enormous pressure to approve losses of questionable causation, or to exaggerate the damages from legitimate claims. Or they can be duped, if local building, medical or other records are forged. It is even worse where judges are compliant or corrupt. These circumstances can have implications under the follow-the-settlements doctrine with respect to both the bad faith exception and the ex gratia exception. At a minimum, cedents should take special care to investigate and document their settlements in high-risk countries.