REINSURANCE ISSUES ARISING FROM MASS TORT SETTLEMENTS

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Mass tort claims continue to overwhelm the US court system and are now becoming more prevalent in the UK, with asbestos being the longest running mass tort litigation in history. This paper presents an overview of reinsurance issues arising from mass tort claims as they make their way along the risk transfer chain to the US and London reinsurance markets.

1. "Follow the Fortunes" Doctrine

Any discussion of reinsurance issues arising from mass tort litigation must begin with an analysis of the most fundamental principle of reinsurance law, the "follow the fortunes" doctrine (often called "follow the settlements" in the UK). It is this doctrine that reinsureds most frequently rely upon to pass along to reinsurers losses arising from mass tort claims.

Under US court precedent, the "follow the fortunes" doctrine requires the reinsurer to reimburse the reinsured (or "cedent") for payment of settled claims so long as the payment is *arguably* within the terms of the reinsured policy. *De novo* review of the cedent's determination to make such payments and to waive arguable defenses to coverage is not permitted. *See, e.g.*, *Mentor Ins. Co. (U.K.) Ltd. v. Norges Brannkasse*, 996 F.2d 506, 516 (2d Cir. 1993); *Commercial Union Ins. Co. v. Seven Provinces Ins. Co.,* 9 F. Supp. 2d 49, 66 (D. Mass. 1998) ("*Seven Provinces I*"), *aff'd*, 217 F.3d 33 (1st Cir. 2000), *cert. denied*, 121 S. Ct. 1084 (2001); *International Surplus Lines Ins. Co. v. Certain Underwriters at Lloyd's*, 868 F. Supp. 917, 920-21 (S.D. Ohio 1994) ("*ISLIC*"); *Unigard Sec. Ins. Co. v. North River Ins. Co.*, 762 F. Supp. 566, 587 (S.D.N.Y. 1991), *rev'd in part, aff'd in part*, 4. F.3d 1049 (2d Cir. 1993).

As New York's highest court has held:

> The rationale behind this doctrine is two-fold: first, it meets the goal of maximizing coverage and settlement and second, it streamlines the reimbursement process and reduces litigation by preventing a reinsurer from continually challenging the propriety of a reinsured's settlement decision.

Travelers Cas. and Surety Co. v. Certain Underwriters at Lloyd's of London, 760 N.E. 2d 319, 328 (N.Y. 2001).

The follow the fortunes doctrine specifically operates to bar the reinsurer from using against its cedent the very coverage defenses the cedent compromises with its policyholder. *North River Ins. Co. v. CIGNA Reinsurance Co.*, 52 F.3d 1194, 1206 (3rd Cir. 1995) ("*Cigna Re*") (permitting reinsurer to use cedent's coverage defenses against it would place cedent in "untenable position of advancing defenses in coverage contests that would be used against them by reinsurers"); *ISLIC*, 868 F. Supp. at 921 (noting that *de novo* review of claims determinations would "give way to a proliferation of litigation"); *American Bankers Ins. Co. of Fl. v. Northwestern Nat'l Ins. Co.*, 198 F.3d 1332, 1335 (11th Cir. 1999) (same); *Christiania Gen'l Ins. Corp. of N.Y. v. Great Am. Ins. Co.*, 979 F.2d 268, 280 (2d Cir. 1992) (reinsurer not entitled to question judgment calls made by its cedent in investigating, compromising, and litigating underlying claim).

A reinsurer may avoid its obligations to follow the reinsured's settlement of an underlying claim *only* if it can establish that the reinsured has acted unreasonably or in bad faith. *Seven Provinces I*, 9 F. Supp. 2d at 66-68 ("The follow the settlements doctrine requires the reinsurer to cover settlements made by the reinsured, as long as they are not fraudulent, collusive, or made in bad faith."); *American Bankers,* 198 F.3d at 1336-37 (holding that the "follow the fortunes doctrine requires a court to find reinsurance coverage unless the reinsurer demonstrates the liability to the insured was the result of fraud and collusion or not reasonably within the scope of the original policy"); *see also Hartford Accident & Indemnity Co. v. Columbia Cas. Co.*, 98 F. Supp. 2d 251, 258 (D. Conn. 2000) ("Therefore, the reinsurer's burden of showing bad faith on the reinsured's part is a high one: the reinsurer must show the reinsured acted with gross negligence, recklessness or bad faith, or that the settlement was not even arguably within the scope of the reinsurance coverage."). "To permit the reinsurer to revisit coverage issues resolved between the insurer and its insured would place insurers in the untenable position of advancing defenses in coverage contests that would be used against them by reinsurers seeking to deny coverage." *CIGNA Re*, 52 F.3d at 1206; *see also American Bankers,* 198 F.3d at 1335 (same); *Christiania*, 979 F.2d at 280 (same); *The Aetna Casualty and Surety Co. v. Philadelphia Reinsurance Corp.,* No. Civ. A. 94-2683, 1995 WL 338488, at *2 (E.D. Pa. June 6, 1995) ("Without 'follow the fortunes' doctrine, reinsureds would be in the impossible position of advancing defenses in coverage contests that could be used against them by reinsurers seeking to deny liability").

Allowing a reinsurer to second-guess its cedent's settlement strategy and coverage compromises would discourage direct insurers from settling coverage disputes with their policyholders or from fulfilling their duty of good faith towards their policyholders. Faced with the choice of defending against an underlying claim vigorously or settling it without hope of reinsurance reimbursement, cedents would be pressured to choose the former: "Cedents faced with *de novo* review of their claims determinations would ultimately litigate every coverage issue before making any attempt at settlement." *CIGNA Re*, 52 F.3d at 1206; *ISLIC*, 868 F. Supp. at 921 (same).

For this reason, courts routinely hold in the direct insurance context that a policyholder may recover the amount of its settlement from its insurer so long as the settlement amount is "reasonable in view of the size of possible recovery and degree of probability of the claimant's success against the" policyholder. *Luria Brothers & Co. v. Alliance Assurance Co.*, 780 F.2d 1082, 1091 (2d Cir. 1986) (quoting *Damanti v. A/S Inger*, 314 F.2d 395, 397 (2d Cir. 1963)); *see generally Uniroyal, Inc. v. Home Ins. Co.*, 707 F. Supp. 1368, 1378-79 (E.D.N.Y. 1988) ("A reasonable settlement binds the insurer to indemnify … [and] a settlement is reasonable when it reflects the probability of loss and the probable size of that loss"); *United States v. Gypsum*, 643 N.E.2d 1226, 1244 (Ill. App. Ct. 1994) ("[I]f an insured settles an underlying claim prior to verdict, it must show that it settled an otherwise covered loss in 'reasonable anticipation of liability.'") (citation omitted); *Vitkus v. Beatrice Co.*, 127 F.3d 936, 945 (10th Cir. 1997) (same).

2. Reinsurance Implications Of Mass Tort Coverage Settlements

The complexities of mass tort litigation have spurred creative and innovative settlements, including settlements between and among mass tort defendants and their insurers. These novel, and often complex, settlements have, in turn, raised difficult reinsurance issues that have tested the bounds of the "follow the fortunes" doctrine. One of the more comprehensive and ambitious coverage settlements in mass tort litigation is the Wellington Agreement, which was entered into between asbestos manufacturers ("producers") and their insurers in 1985.

The Wellington Agreement established the Asbestos Claims Facility ("ACF"), a non-profit claims handling center that coordinated claim payments on behalf of dozens of asbestos defendants. The signatories to the agreement sought to reduce asbestos litigation awards while lowering the associated costs. The agreement encouraged settlements in place of costly litigation.[1] The Wellington Agreement also provided an alternative dispute resolution ("ADR") procedure for certain disputes between insureds and their insurers.

Pursuant to Wellington, each producer agreed to pay a share of every settled or adjudicated asbestos claim asserted against one or more Wellington signatory producers in accordance with a producer allocation formula, whether or not the claimant alleged exposure to its asbestos products. By agreeing to this allocation formula for all claims, the producers avoided the need to assert cross-claims against each other in the underlying asbestos suits. In

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1 The ACF was dissolved after a few years of operation. However, the insurance coverage provisions of the Wellington Agreement are perpetual. *See* Wellington Agreement, §III.3.

two cases reinsurers argued that payments made by insurers on behalf of producers under the producer allocation formula were not covered losses from a reinsurance perspective absent proof that the underlying claimants were actually exposed to the insured's product.

In *Unigard Security Ins. Co. v. North River Ins. Co.,* 762 F. Supp. 566 (S.D.N.Y. 1991), *aff'd in part, rev'd in part on other grounds*, 4 F.3d 1049 (2d Cir. 1993), the federal district court, after a bench trial, ordered a reinsurer to reimburse its cedent for payments made pursuant to the producer allocation formula based upon application of the "follow the fortunes" doctrine. The court held that the Wellington Agreement was a good faith settlement of claims and involved payments reasonably falling within the terms of the reinsured policies. 762 F. Supp. at 586. The court rejected the reinsurer's argument that payments under the producer allocation formula were not covered:

> While under the allocation formula [the insured] sometimes contributed to settlements of claims on which it might not legally have been liable, at the same time [the insured] benefited from the fixed percentage contributions that other producers made to claims on which [the insured] would have been chiefly liable.

762 F. Supp. at 589.

The court in *Hiscox v. Outhwaite*, 2 Lloyd's Rep. 524 (Q.B. Comm. Ct. 1991), reached the opposite conclusion:

> The disputed payments were in respect of non-insured claims, which by definition were not within the scope of the reinsurance contract. They did not become insured, and therefore reinsured, claims, merely because [the signatory insurers] agreed to treat them as if they were.

2 Lloyd's Rep. at 531.

These two divergent decisions highlight the difficulties facing insurers when confronted with novel settlements in the context of mass tort litigation: Will a novel mass tort settlement be viewed as a reasonable, good faith compromise, thereby requiring the reinsurer to honor the insurer's payments under the "follow the fortunes" doctrine? Or will a court determine that the settlement constitutes a voluntary agreement on the part of the insurer to assume liability which does not fall within the scope of the reinsured policy?

3. Reinsurance Issues On The Horizon

Asbestos litigation will continue to raise complex reinsurance issues. According to a Rand study on U.S. asbestos litigation, the asbestos crisis is far from over. The number of asbestos claims filed annually has *risen* in recent years; the total number of claims filed to date is estimated to be over 500,000. Both cancer and non-cancer claims have increased. Many asbestos defendants have spent over $1 billion on asbestos litigation, and U.S. insurers have paid approximately $21.6 billion for indemnity and defense. There have been scores of bankruptcies filed by asbestos defendants as a result of their asbestos liabilities, with many major asbestos defendants filing for bankruptcy within the past three years. And companies that were once viewed as peripheral players are now being targeted as major defendants by the asbestos plaintiffs' bar in new filings. *Asbestos Litigation in the U.S.: A New Look at an Old Issue* (Rand Institute for Civil Justice August 2001).

The asbestos plaintiffs' bar and asbestos defendants continue to pressure the insurance industry to participate in bulk settlements that often take a novel approach toward compensating claimants. Two of the more significant pressure points being applied to insurers are the "non-products issue" and the "UNR issue."

The "non-products" issue relates to the exposure insurers face for asbestos claims arising from their insureds' asbestos installation activities. Such claims arguably fall outside the scope of the products/completed operations hazard and therefore would not be subject to any products aggregate limits. To the extent that an insured can establish that a significant extent of its exposure is attributable to installation activities, then its insurers may face potentially unlimited liability for such exposure. Insurers facing such enormous liability for non-products claims are under great pressure to participate in settlements that cap their liability, but may face a protracted battle with their reinsurers over coverage.

The "UNR issue" relates to the decision issued in 1991 from the United States Court of Appeals for the Seventh Circuit in *UNR Industries, Inc. v. Continental Cas. Co.,* 942 F.2d 1101 (7th Cir. 1991). The case arises out of UNR's bankruptcy filing in 1982. In 1989, UNR filed a plan of reorganization under which UNR would transfer nearly two-thirds of its stock to a trust ("Trust") operated for the exclusive benefit of UNR's asbestos claimants. The stock to be transferred to the Trust had a market value of $150 million. UNR's plan of reorganization valued UNR's asbestos claims at $254 million. Thus, there was a $104 million shortfall between the value of the Trust and the value of UNR's asbestos claims.

The bankruptcy court confirmed UNR's plan of reorganization with the consent of UNR's asbestos claimants. In so doing, the bankruptcy court held that UNR's asbestos claims would "'be fully settled and satisfied' by the distribution of UNR's stock to the Trust." 942 F.2d at 1104 (citing UNR's Consolidated Plan of Reorganization, March 14, 1989, Article III, confirmed by Confirmation Order, June 1, 1989). After UNR emerged from bankruptcy, UNR sued its insurers, including Continental Casualty Company ("CNA"), for a declaration of their insurance obligations with respect to asbestos claims.

The CNA policy provided that CNA "will indemnify the insured for *loss* in excess of the total applicable limits of underlying insurance." The policy defined "loss" as "the sums paid as damages in settlement of a claim or in satisfaction of a judgment." The CNA policy further provided that "no action" would lie against CNA unless the amount of UNR's obligation to pay shall have been finally determined by "judgment" against UNR or by "settlement" among UNR, the claimant, and CNA. *Id*. Based on these policy provisions, the district court dismissed UNR's claims against CNA, concluding that the asbestos claimants had not yet obtained a judgment or settlement from UNR that would trigger CNA's obligations. The district court also concluded that, in the future, UNR would be able to enforce CNA's obligations only by proving the amount that specific asbestos claimants actually received on their claims. The Seventh Circuit reversed. The appellate court held instead that UNR had suffered a "loss" under the provisions of the CNA policy because UNR's confirmed plan of reorganization constituted a "judgment or settlement" in the amount of $254 million that was binding on CNA:

> The question is whether UNR has suffered any "loss" under these [policy] provisions. It has. UNR's bankruptcy resulted in a judgment or settlement (which one does not matter) against UNR in the amount of $254 million on the asbestos claims. . . . The bankruptcy reorganization was a judgment or settlement and so triggers CNA's insurance obligations. The reorganization required UNR to pay a sum certain (the stock, which had a market value of $150 million) in satisfaction of the asbestos claims. The order confirming that reorganization was final and appealable. And the order is binding.

Id. at 1104-5.

In short, the Seventh Circuit found that UNR's "loss" arose because UNR's confirmed plan of reorganization constituted a judgment or settlement in the amount of $254 million, which triggered CNA's insurance obligations. The *UNR* case remains part of the landscape that shapes insurers' responses to settlement initiatives, and will likely be discussed in the context of reinsurance disputes involving bankrupt insureds as part of analyzing the reasonableness of cedents' coverage determinations.