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Questions relating to follow the settlements in reinsurance under English law with comparative reference to the laws of Germany and the USA

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Scientific debate

Abstract

For the reinsurance markets follow the settlements is a crucial principle. The law has been developing in the most important jurisdictions and this article attempts, by taking key questions, to analyse these developments and differences in the English, US and German jurisdictions. The analysis indicates differences as well as similarities between these jurisdictions and further that there are areas which are not well settled, in particular allocation of reinsurance losses to the following reinsurer.

Key words: Reinsurance, follow the settlements, ex-gratia, back-to-back, claims cooperation/control, inspection, allocation.

1. INTRODUCTION

Of utmost importance to a reinsured is to obtain trouble free inwards settlement of claims. The reinsured wishes to know that if it settles a claim, its reinsurers will pay their share without questioning the reinsured's assessment of liability to pay and, where possible, even ex gratia payments – that they will follow the settlements. This is particularly the case in "fronting" situations where the reinsured will retain only a small percentage of the risk. In turn the reinsurer does not wish to pay more than its proper share and, particularly in "fronting" situations, will wish to control the handling and settlement of claims by virtue of a claims

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control clause. Often, however, the reinsured will only agree to a claims co-operation clause which only allow the reinsurer to be associated with the handling and settlement of claims which, from the point of view of the reinsurer, may not be satisfactory.

The issue is frequently the subject of dispute in various jurisdictions. In this article, we will seek to analyse the approach taken by the courts in England and compare this where appropriate with the US and Germany by reference to certain key questions. In Germany, however, there are very few Court decisions regarding reinsurance in contrast to England and the United States.

2. THE POSITION WHERE THERE IS NO FOLLOW SETTLEMENTS CLAUSE: CAN THE OBLIGATION BE IMPLIED? THE INTERPRETATION OF INDIVIDUAL FOLLOW THE SETTLEMENTS CLAUSES.

In English law there is no presumption or implied term in the reinsurance context that a reinsurer will follow the settlements of its reinsured. This is in contrast to the position in the United States and Germany where it is arguable that such a clause is implied.

As early as 1922, the English court held that it was "well settled that (subject to any provision to the contrary in the reinsurance policy) the reassured, in order to recover from their underwriters, must prove the loss in the same manner as the original assured must have proved it against them, and the reinsurers can raise all defences which were open to the reassured against the original assured."¹

¹ *In Re London County Commercial Reinsurance Office Limited* (1922) 2 CH 67 (at pg 80).

This principle was reaffirmed in 1996 by the House of Lords:

"There are only two rules, both obvious. First, that the reinsurer cannot be held liable unless the loss falls within the cover of the policy reinsurance and the cover created by the reinsurance. Second that the parties are free to agree on ways of proving whether these requirements are satisfied. Beyond this, all the problems come from the efforts of those in the market to strike a workable balance between conflicting practical demands and then to express the balance in words."²

Thus, under English law, there is a need for a specific follow settlements³ clause in order to bind the reinsurer to pay in accordance with settlements made by its reinsured. Even then such clauses tend to be interpreted relatively strictly by the courts in accordance with ordinary rules of construction of contracts.⁴

As referred to above, in Germany there are no court decisions on the meanings of either follow the settlements or follow the fortunes⁵. In reality the vast majority of reinsurance contracts to which German law applies contains a follow the settlements clause. The authorities are undecided where in the absence of such a clause the principle would be implied although it is believed the prevailing opinion is in favour of an implied clause.⁶ The reasoning behind the automatic application is that the concept is founded in reinsurance customs and practice or even customary law. The argument in support is based upon the commercial code.⁷

² *Hill v Mercantile* (1996) *Ll L Rep* 341.

³ "Follow fortunes" clauses, in other words, clauses which use the language of "follow fortunes" are rare in English market practice and have received little consideration by the English courts. German reinsurance law distinguishes between Follow the Settlements and Follow the Fortunes. The distinction is that under the Follow the Fortunes principle the direct insurer's "Insurance Fortunes" are borne and shared by the reinsurer whereas the insurer's "Commercial Fortunes" are not.

⁴ In brief, the English approach is that words are to be given their ordinary meaning unless the context requires otherwise. Clauses are construed in the context of the document as a whole and also by reference to the factual matrix which includes the commercial purpose of the contract and facts known to both parties to the contract at the time it is entered into (*Investors Compensation Scheme v. West Bromwich Building Society* [1997] UKHL 28; [1998] 1 All ER 98). Follow settlements clauses are no exception.

⁵ The probable reason for this is that most reinsurance disputes to the present in Germany have been either settled amicably or in confidential arbitration proceedings.

⁶ Gerathewohl, *Rückversicherung*, Chapter 7, 2.5.2.3; Schwepcke, "Rückversicherung" in *Münchener Kommentar VVG*, 28.

⁷ HGB §346 - "In consideration of the significance and effect of acts and omissions, merchants shall make due allowance for the customs and usage practised in trade."

Although they are conceptually distinct doctrines, courts in the United States frequently use the terms "Follow the Settlements" and "Follow the Fortunes" interchangeably.⁸ There is a body of case law in the United States where the follow the settlements doctrine has been implied even in the absence of an express provision in the reinsurance agreement.⁹ In the cases, the courts have treated the issue as a question of fact and have credited testimony from industry experts that the Follow the Settlements doctrine, as a matter of custom and practice, is inherent in and essential to the reinsurance relationship. Other courts have resisted in applying follow the settlements obligations in the absence of express language.¹⁰ A prominent commentator has argued that the cases implying the doctrine have done so based on the misreading of earlier case law and commentaries and takes the position that "the best modern scholarship, the judicial history of the subject...and the general law of contract indemnity unite in confirming that there is no implied general obligation to follow settlements in the absence of an express clause to that purpose."¹¹

In English law, there is no follow settlements clause, the reinsured has to prove that it was liable under the original insurance, both in terms of legal liability and amount. Most obvious proof would be a court judgment or a binding arbitration award. Indeed the English court has held that it is an implied term of a reinsurance contract that the parties to a reinsurance agreement are to be assumed to have intended that a foreign judgment is binding on them both.¹² A reinsurer who wishes to challenge the judgment against a reinsured will have to satisfy the recognising court either that the reinsured failed to defend the action properly or that the judgment was perverse.¹³

⁸ *Employers Reins. Co. v. Mass. Mutual Life Ins. Co.* ("Mass Mutual"), 654 F.3d 782, 790 n.3 (8th Cir. 2011). U.S. case law discussing "follow the fortunes," therefore, should be consulted when analyzing application of the "follow the settlements" doctrine to a reinsurance agreement.

⁹ *Trenwick*, 764 F.Supp.2d at 296; *Aetna Cas. & Sur. Co. v. Home Ins. Co.*, 882 F.Supp. 1328 (S.D.N.Y. 1995); *International Surplus Lines Ins. Co. v. Certain Underwriters at Lloyd's of London*, 868 F.Supp. 917 (S.D. Ohio 1994).

¹⁰ *North River Ins. Co. v. Employers Reins. Corp.*, 197 F.Supp.2d 972, 984–86 (S.D. Ohio 2002).

¹¹ Graydon S. Staring and Christopher P. Staring, *Law of Reinsurance*, § 18:2 (Thomson Reuters 2011).

¹² *Commercial Union Assurance Co plc v NRG Victory Reinsurance Limited* [1998] 2 AER434, the Court of Appeal rejecting the argument that a foreign judgment is no more than "evidence" of a reinsured's liability.

¹³ In the Commercial Union case (*ibid*), although the point did not actually arise for decision, the Court of Appeal did not

Where the reinsured does not have a judgment or award to prove liability because the claim has been settled, the reinsured remains liable to prove the liability to the original insured. This can be difficult as demonstrated in **Commercial Union Assurance Company Plc & Ors v. NRG Victory Reinsurance Ltd.**¹⁴ Here the reinsured settled the claim on the advice of Texan lawyers that although clean-up costs for pollution were arguably excluded under the policy, the reinsured was likely to lose because liability was going to be determined by a non-specialist judge directing Texan jurors often known to be unfavourable to insurers. The court held that follow settlement wordings required a reinsured to demonstrate actual legal liability under the policy; it was not enough, for instance in this case, to produce an affidavit from a Texas lawyer testing to a strong likelihood that insurers would lose at trial.¹⁵

The result therefore in English law is that in the absence of a follow settlements clause, the reinsured is required to prove its loss and entering into a favourable settlement will not suffice even if that settlement will in practice reduce the ultimate liability of both the reinsured and the reinsurer. This case further highlights a frequent and serious difficulty for a reinsured. If the reinsured had taken the case to trial and lost, it would arguably have been in a better position to recover under the reinsurance; on the other hand, this exposes the reinsured to greater losses on the underlying than if it had taken the opportunity to settle at a significant discount. Further, even if the reinsured took the claim to judgment with an eye to reinsurance recovery, this would not guarantee against challenge by reinsurers on underlying liability, for example, that the underlying court decision was manifestly perverse.

think it enough that a court consisting of an inexpert judge and a jury known to be biased against insurance companies would be sufficient.

¹⁴ *Ibid.*

¹⁵ The Court of Appeal regarded this document merely as containing “predictions” which “did not bite on the question of whether the evidence demonstrated legal liability under the insurance contracts” even though its conclusions had not been contested by reinsurers.

3. THE EXTENT TO WHICH IT IS POSSIBLE TO LIMIT THE REINSURER’S RIGHT TO CHALLENGE SETTLEMENTS. THE EFFECT OF EX GRATIA AND OTHER EXCLUSIONS IN THE CLAUSE. THE POSSIBILITY OF CHALLENGING THAT A SETTLEMENT HAS NOT BEEN CONCLUDED HONESTLY AND IN A REASONABLE AND BUSINESSLIKE MANNER

In English, American and German law it is a common principle of follow settlements that a reinsurer can challenge the claim based on a settlement on the ground that it does not fall within the scope of the reinsurance cover.

Earlier forms of follow settlements clauses in English contracts took the form of “to pay as might be paid thereon” or “to pay as may be paid thereon and to follow their settlements”. There was, however, a great deal of uncertainty as to the nature and effect of such clauses until the case **Insurance Company of Africa v SCOR (UK.) Reinsurance Company Ltd.**¹⁶

In this case, the reinsurance contract contained a follow the settlements clause in the form of a London market “full reinsurance clause” which read:

“Being a Reinsurance of and warranted same...terms and conditions as and to follow the settlements of the Insurance Company of Africa...”

The court decided that the follow settlements clause meant that reinsurers agreed to indemnify insurers in the event that insurers settle a claim provided that the claim settled falls within the risk covered by the policy of the reinsurance as a matter of law, and that in settling the claim the insurers have acted honestly and have taken all proper and businesslike steps in making the settlement. (“The Two Provisos”). The presumption was that reinsurers are entitled to rely on the honesty and professionalism of insurers and that even if an insured’s claim later turns out to have been fraudulent, the reinsurer must follow the settlement of the reinsured acting honestly and in a businesslike manner.

It has since been held that a distinction needs to be made between having to prove that an original loss falls within the cover provided by the direct contracts, and having to prove that a **claim has been recognised by insurers** as such. In the former, one is examining what in fact actually happened and in the latter how the claim was recognised/classified by the insurers¹⁷. Under

¹⁶ [1985] 1 Lloyd’s Rep 312.

¹⁷ *Assicurazioni Generali v CGU International Insurance plc* [2004] EWCA Civ 429; *Equitas Limited v R&Q Reinsurance Company Limited* [2009] EWHC 2787.

the Scor provisos, the emphasis is on the latter so that the reinsured does not need to establish that the claim actually fell within the risks covered by the insurance contract. The reinsurer then cannot re-open the reinsured's classification of the loss so long as it was bona fide and businesslike, even if the reinsured's classification was in fact wrong.

It should be noted that this is the result where the follow settlements clause is unqualified as in Scor. Where the clause contains a proviso such as "provided the losses fall within the terms and conditions of the original policies and this reinsurance", the reinsurer is entitled to reopen the reinsured's classification.¹⁸

Scor represented a high water mark of judicial support for a reinsured's attempt to make reinsurers follow settlements without question. Subsequent attempts to make the reinsured's load even lighter have not met with a great degree of success.

3.1 "...Liable or not liable..."

In **Charman v Guardian Royal Exchange**¹⁹ the Court held that the words liable or not liable qualifying a loss settlement did not enable a reinsured to remove the obligation to settle its liabilities in a businesslike fashion on the basis that if a reinsured attempted to pass on a claim knowing there was no liability, the settlement could not be in good faith let alone businesslike.²⁰

3.2 "Settlements whether by way of compromise, ex gratia or otherwise shall in every respect be unconditionally binding".

Words as above were used in **Hiscox v Outhwaite (no 3)**²¹. Even with words of this nature it was held that a reinsurer is always entitled to raise issues as to the scope of the reinsurance contract and, where the risks are co-extensive with those of the underlying insurance, the reinsured is not precluded from raising such issues even where there is a follow of the settlements clause as this is the only sure protection that the reinsurer has against being called upon to indemnify the reinsured against payments not legally due to the original insured. The reinsurer is always at liberty to rely on, for example, a late notification clause in the reinsurance even where there is a follow settlements clause.

¹⁸ *Hill v Mercantile and General Reinsurance plc* [1996] 3 All ER 865.

¹⁹ [1992] 2 Lloyd's Rep 607.

²⁰ In this case the Court also made clear that the burden of proof was upon the reinsurer to show that a reinsured did not settle in good faith or in a businesslike way.

²¹ 1991 2 Lloyd's Rep 2524.

3.3 "...To follow without question the settlement of the reinsured..."

Here it has been established²² that the words "without question" did not have the effect of limiting the application of the second Scor proviso (bona fide and businesslike settlement) given that they did not remove the insured's obligation to act honestly and take all reasonable and proper steps in settling the claim.

It will be seen from the foregoing that in English law attempts to craft a follow settlements wording such that the reinsurer cannot challenge settlement made by the reinsured have not been successful despite fairly clear language. It remains to be seen whether stating this intent explicitly in the form of a waiver clause might achieve the intended result. In other words, a clause including words along the lines of "reinsurers irrevocably waive the right to challenge settlements made by the reinsureds..." It may be however that such wording would be commercially unacceptable.

In the United States the scope of the follow settlements doctrine has been articulated in various ways but can be summarised as follows: The doctrine requires a reinsurer to accept the reinsured's good faith decisions concerning the underlying insurance terms and claims against the underlying insured.²³ A reinsurer may not challenge a reinsured's settlement unless it is fraudulent, collusive or otherwise made in bad faith²⁴, or if the payments are clearly beyond the scope of the original policy²⁵, or if it conflicts with the specific terms and conditions of the reinsurance agreement. A reinsurer may not challenge a reinsured's decision to settle as long as it is arguably within the terms of the direct policy, even if not "technically covered by it" and if the reinsured acted in good faith.²⁶

German law also imposes the duties of acting honestly and in a reasonable and businesslike manner. The reinsured has the right to decide if and how to

²² *Assicurazioni Generali SpA v CGU International Insurance Plc and Others* [2003] Ll. L. Rep IR 725.

²³ *North River Ins. Co. v. ACE Amer. Reins. Co.* ("ACE"), 361 F.3d 134, 139–40 (2d Cir. 2004).

²⁴ *Mass. Mutual*, 654 F.3d at 790–91, quoting *Travelers Cas. & Sur. Co. v. Ins. Co. of No. Amer.*, 609 F.3d 143, 149 (3d Cir. 2010); *ACE*, 361 F.3d at 139.

²⁵ *Christiana Gen. Ins. Corp. of NY v. Great Amer. Ins. Co.*, 979 F.2d 268, 280 (2d Cir. 1992) (the follow the fortunes doctrine insulates a reinsured's liability determinations from challenge by a reinsurer unless they are fraudulent, in bad faith, or the payments are clearly beyond the scope of the original policy or in excess of the reinsurer's agreed to exposure).

²⁶ *Mass. Mutual*, 654 F.3d at 791, quoting *Am. Employers' Ins. Co. v. Swiss Reins. Am. Corp.*, 413 F.3d 129, 132 (1st Cir. 2005).

settle a claim²⁷. This right however is not unlimited or unrestricted; the reinsured being bound by the standard of prudent business management. Although the definition of these duties might be difficult, if the reinsured breaches them wilfully or with serious carelessness the reinsurer is not bound to follow the settlement. In carrying out any settlement the reinsured is obliged to take into consideration the interests of the reinsurer. Slight negligence however does not relieve the reinsurer from liability but if there is serious carelessness the reinsurer is not bound. The test for the reinsured acting as if it were a prudent business person is the standard which the reinsured would apply if managing its own business, that is without having any reinsurance in place²⁸.

In German law the reinsurer does not have to follow ex gratia payments.²⁹ In the United States there is also no obligation to indemnify for a purely ex gratia payment unless the reinsurance contract expressly provides so.³⁰

In the United States some Courts have also recognised an exception to the doctrine where a cedant has failed to conduct a "reasonable businesslike investigation" or has committed "gross negligence" or "recklessness" in handling a claim. This chimes with German law where gross negligence would also relieve the reinsurer of liability (as compared to slight negligence). Although in the United States this places a heavy burden of proof on the reinsurer, it does provide some protection for the most egregious claims handling conduct, even where it does not rise to the level of fraud or collusion.³¹

As in Germany and the USA (as referred to above), in English law an ex gratia payment would not be considered a businesslike settlement. An ex gratia payment is ordinarily understood to be one which is entirely voluntary, that is, where the insurer is under no legal liability to make it. Some follow settlements clauses

²⁷ Gerathewohl 2.5.2.2.

²⁸ Schwepcke, *Rückversicherungsrecht*, 30.

²⁹ Schwepcke, *Rückversicherungsrecht*, 31.

³⁰ *Granite State Ins. Co. v. ACE Amer. Reins. Co.*, 849 N.Y.S.2d 201, 203–204 (N.Y. App. 2007) (the follow the fortunes doctrine does not apply to a settlement that is "an ex gratia payment, i.e., one made by a party that recognizes no legal obligation to pay, but makes payment to avoid greater expense, as in the case of a settlement by an insurance company to avoid the cost of a suit"); *Michigan Millers Mut. Ins. Co. v. North Amer. Reins. Corp.*, 452 N.W.2d 841, 843 (Mich. 1990) (follow the fortunes did not apply to cedant's payments to insured where insured's losses did not exceed the direct policy's attachment point).

³¹ *Suter v. General Acc. Ins. Co. of Am.* 2006 WL 2000881 (D.N.J. 2006), vacated pursuant to settlement, *Goldman v. Gen. Acc. Ins. Co. of Am.*, 2007 WL 2781935 (D.N.J. 2007).

purport to include "ex gratia" or "without prejudice"³² settlements; others expressly exclude them. Where ex gratia and without prejudice settlements are expressly covered, the reinsurer can still raise issues on whether or not the loss actually falls within the reinsurance contract in reliance on the first Scor proviso.³³

Where ex gratia and without prejudice settlements are expressly excluded, particular care must be taken in considering the basis of the underlying settlement and how it is worded. In **Faraday Capital Limited v Copenhagen Reinsurance Company Limited**³⁴ the follow settlements clause in the contract expressly excluded without prejudice payments. The settlement between Faraday and the original insured had stated that it was "without prejudice to... the parties' respective positions". The Court decided in favour of reinsurers, both refusing to receive evidence to the effect that the reinsured did in fact believe it was liable under the original policy and refusing to look behind the formal words in the settlement agreement holding that the parties had chosen expressly to exclude without prejudice settlements.

This case in English law underlines the importance of a reinsured being aware of its outwards reinsurance terms and not jeopardising cover by the use of language which might inadvertently bring it outside the scope of cover. Care must be taken to consider the legal basis upon which a settlement is concluded.

4. THE BACK TO BACK PRESUMPTION: DOES THIS UNIFORMLY EXIST AND, IF NOT, IN WHAT CIRCUMSTANCES WILL IT BE FOLLOWED BY THE COURTS?

Where facultative reinsurance contracts are concerned, parties usually intend the reinsurance cover to match the direct policy terms (except of course in relation to matters such as limits and deductibles). In the London market, this is often achieved by stating that the reinsurance is to be on the "same terms and conditions as original", or similar, which has the effect of incorporating the wording of the underlying into the reinsurance contract. The position is less clear where there is no such language but the language of both contracts is very similar. In this context the English Courts have devised a useful presumption that at least in the context of facultative reinsurance, the parties

³² A settlement where the insurer simply makes no admission of legal liability.

³³ *Hiscox v Outhwaite* (No.3) [1991] 2 Lloyd's Rep 524.

³⁴ (2006) EWHC 1474 (Comm).

to reinsurance would have intended that the meaning and effect of equivalent provisions in the insurance and reinsurance contracts would be the same. There is no presumption in US law; the terms of the reinsurance agreement govern the scope of coverage and are interpreted according to general rules of contract construction.³⁵ A number of US Courts have considered the issue of concurrency in instances in which the reinsurance agreement contains a “follow form” clause. The frequently articulated rule is that where a follow form clause is found in the reinsurance contract, concurrency between the policy of reinsurance and the reinsured policy is presumed, such that a reinsurance will be construed as offering the same terms, conditions and scope of cover as exists in the reinsurance policy in the absence of explicit language to the contrary.³⁶ Where the reinsurance agreement, however, is sufficiently clear, specific limits on coverage exercise control over follow form clauses.³⁷

In Germany there is also no corresponding concept of back to back. A reinsured would have to rely on the basic principles of contract law and of Follow the Fortunes. Normally, however, in the absence of an express statement to the contrary, the intentions of the parties to a reinsurance contract would normally be interpreted on the basis that the parties would have wished the terms and conditions of the policies to be interpreted identically.

In English law the two important cases are **Forsikringsaktieselskapet Vesta v Butcher**³⁸ and **Groupama Navigation v Catatumbo**.³⁹ In the former, the Court well articulated the presumption as follows: “Where a contract provides that its terms and conditions are to be the same as those of another contract and where its clear commercial purpose is to provide a corresponding cover to that provided by the other contract, then, unless some other powerful considerations intervene the conclusion must be that there is an intention that both contracts are to

³⁵ 1A *Couch on Insurance*, §9:13 (3d ed.). See also Graydon Staring, *Law of Reinsurance*, §13:3 (Thomson Reuters 2011) (“But there is no general rule that reinsurance must follow form and be congruent and, in the end, the reinsurance contract stands on its own terms.”)

³⁶ See, e.g., *Travelers Cas. & Sur. Co. v. Ins. Co. of North America*, 609 F.3d 143, 166 (3d Cir. 2010), quoting *Aetna Cas. & Sur. Co. v. Home Ins. Co.*, 882 F.Supp. 1328, 1337 (S.D.N.Y. 1995).

³⁷ See, e.g., *Travelers Cas. & Sur. Co. v. ACE Amer. Reins. Co.*, 392 F.Supp.2d 659, 665 (S.D.N.Y. 2005), citing *Commercial Union Ins. Co. v. Swiss Re. Amer. Corp.*, 413 F.3d 121, 128 (1st Cir. 2005).

³⁸ (1986) 2 All E.R 488 (at 504c-d).

³⁹ (2000) CLC 1534.

be governed by the same law”. Both these two cases concern breaches of warranty where, although the insurance and reinsurance contracts were governed by different applicable laws, the presumption resulted in the same legal effect as to a breach of warranty being given in both contracts (English law has a much stricter warranty regime than most other jurisdictions).

The presumption in English law with regard to back to back, however, received a setback in the recent House of Lords decision in **Wasa International Insurance Company Limited v Lexington Insurance Company**.⁴⁰

Lexington, who was reinsured by Wasa and AGF, had participated in a long running property and liability insurance programme covering Alcoa headquartered in Pennsylvania but with various sites in the United States. Lexington’s cover was for three years from 1 July 1977 to 1 July 1980, a relatively brief portion of Alcoa’s programme which went back into the 1950s and continued to 1984. AGF and Wasa provided facultative reinsurance to Lexington on back to back terms including the exact same period of cover. The insurance had no express choice of law clause; it was agreed that the reinsurance treaty was covered by English law.

Alcoa suffered, from 1942 to 1986, damage by way of contamination of ground water and soil at many sites in nineteen different US states. Alcoa sued a number of insurers, including Lexington, in Washington Courts. The Judge found as a fact that the damage occurred on a broadly linear basis so it was possible to identify approximately how much damage had occurred in any one year. The court decided to apply Pennsylvania law to all the issues as the place most closely connected with the formation of the relevant insurance contracts.

Almost all the other 17 insurers escaped liability based on exclusions or time bar provisions in their policies. The question therefore was whether Lexington’s liability was limited to losses occurring during the 3 years or whether Lexington remained responsible for all the damage which had occurred between 1942 and 1986.

The Washington Supreme Court applying Pennsylvanian law held that in the absence of an express exclusion for damage occurring outside the policy period, the Lexington policy responded to damage over the entire 44 year period, so long as some of the damage occurred during the 3-year policy period. This was on the basis that all insurers were jointly and severally liable to Alcoa. Lexington was then faced with a claim of about US\$180 million.

⁴⁰ (2009) UKHL 40. This was the last Judgment by the House of Lords before it was replaced by the Supreme Court as the final English Court of Appeal.

Although no one suggested that the US decision was wrong, it was established that if the case had been tried in a number of other US states, the outcome would have been different and Lexington would only have been liable for the pro rata loss applicable to its 3-year period of cover. Lexington then settled with Alcoa for approximately US\$103 million.

The sole issue in the reinsurance dispute was whether Wasa and AGF could limit their liability to the 3 year period specified or whether they had to pick up their percentage share for the entire period of Alcoa's loss.

The first instance decision in favour of reinsurers that there was no cover outside the stated period, was overturned by the Court of Appeal which held that despite the different governing laws, the contracts were meant to be back-to-back; that is applying the back-to-back presumption developed in Vesta and Catatumbo, the reinsurance must have been intended to have the same meaning as the insurance, whatever that might have been, including the period clause.⁴¹ The House of Lords reversed the Court of Appeal holding that the back-to-back presumption did not have the radical effect of extending the temporal scope of cover which was described to be of "fundamental importance" under English law. Drawing a distinction between the facts of Wasa and those of Vesta and Catatumbo, the court held in the earlier cases it had been possible for the parties at the outset to identify the foreign law which would govern the insurance. In Wasa, however, at the reinsurance contract's inception there was "no identifiable system of law applicable to the insurance contract which could have provided a basis for construing the contract of reinsurance in a manner different from its ordinary meaning in the London insurance market." The outcome depended on the particular US court in which the claim under the direct policy was resolved; a different decision could have come from another US court. One might derive from this distinction that the parties might wish to clarify in a reinsurance contract the extent to which the period of reinsurance can be affected by a court judgment extending that period in relation to the underlying cover. For example, reinsurers might wish to insist that the period clause is paramount and will not be affected by any court's decision extending the period of the underlying.

The position in relation to non-proportional reinsurance is different:⁴² where reinsurers are writing an excess of loss treaty of a layer or the whole of a stipulated

⁴¹ Although the US decision may never have been anticipated by the reinsurers, the Court of Appeal considered that part of the bargain with Lexington had been to share the risk of an unfavourable development in the law.

⁴² *Axa Reinsurance UK Ltd v. Field* [1996] 3AER 527.

account, there is no reason for such a presumption as such a contract cannot in a real sense be back-to-back.

5. HOW DOES FOLLOW THE SETTLEMENTS INTERACT WITH CLAIMS COOPERATION / CONTROL AND INSPECTION CLAUSES?

Where a reinsured wishes to have an effective "follow settlements" wording, care should be taken to avoid an inconsistent claims cooperation or control clause under which reinsurers would not be bound to settlements which they have not approved. This could have the effect of emasculating a "follow settlements" clause.⁴³ The position in the United States is the same as English law. In Germany the position is somewhat different and this is probably a reflection of the fact that follow the settlements clauses are implied. The breach of a claims cooperation/control clause is an infringement of the reinsurance contract which does not entitle the reinsurer to reject the claim but could lead possibly to a claim for damages. To succeed the reinsurer would have to establish that the clause was infringed by the reinsured at least negligently and had there been no such breach, the reinsurer would have instructed the reinsured in a way which would have limited both the claim upon the reinsurer and the difference for which the reinsurer should be compensated.

With regard to inspection clauses, the principles referred to above in respect of claims cooperation / control clauses in German law apply. In English law, the relationship between the obligation of the reinsurer to follow settlements and the reinsured's obligation to disclose his books and records was considered in **Phoenix General Insurance Co of Greece v. Halvanon Insurance Co**.⁴⁴ It was decided that the reinsurer's obligation to follow was paramount and could be enforced even though the reinsured was in breach of contract by failing to submit to inspection. This same principle is extended to applied inspection clauses in **Baker v. Black Sea & Baltic Insurance Co Ltd**.⁴⁵ It was further held that the reinsured's refusal to allow inspection did not have any impact upon the follow settlements clause, for example, in amounting to evidence that the direct settlement had not been reached by the reinsured in a bona fide businesslike fashion.⁴⁶

⁴³ *ICA v Scor*.

⁴⁴ [1985] 2 Lloyd's 599.

⁴⁵ [1998] 2 AER 833.

⁴⁶ This approach was followed in the more recent case of *Eagle Star Insurance Company Ltd v J.N Cresswell and Others* [2004] 1 CLC 926.

The US position is similar in that refusal to allow inspection alone is not a basis to override the follow settlements doctrine. However, a sufficiently egregious failure to co-operate could in theory lead to the voiding of the reinsurance cover. Typically however, a court or arbitration panel would order a cedant to make its files available to give the reinsurer an opportunity to raise any available defences and at the point the follow settlements doctrine would be applied.

6. THE ALLOCATION OF SETTLEMENTS WHERE THIS DIFFERS FROM THE BASIS UPON WHICH THE REINSURED HAS SETTLED AND IS NOW PRESENTING TO THE REINSURER.

What happens if claims are settled by the reinsured on a global basis and there are a number of reinsurance contracts to which the reinsured can potentially allocate claims which were settled? Is the reinsured able to allocate the settlement for the purpose of maximising reinsurance recoveries? What if the global settlement did not contain any allocation of specific sums to individual claims and some of the claims fall outside terms of the reinsurance contracts? Another issue is where it may not be obvious into which reinsurance year/s some losses fall. What happens when the reinsured cannot prove what loss occurred when in relation to successive periods of cover? Is the reinsured bound to allocate losses to match the inwards claims or is it able to allocate in a way so as to maximise reinsurance recoveries?

We start from the basis of the consistent holding in the English cases described above that even where there is a follow settlements clause, the reinsurer can always raise issues of whether particular claims and settlements fall within the scope of the reinsurance contract. This position is the same, as referred to above, in US and German law. The burden of proof will be on the reinsured to show that the claims presented fall within the reinsurance contract, both as to liability and quantum. Where the reinsured is unable to prove exactly when particular losses occurred, the English court has shown itself willing to assist by making certain assumptions in situations where it is clear there is cover and the only issue is allocation to particular periods of cover. US law, as seen below, takes a much broader approach to what the reinsured may do by way of allocation in seeking recovery.

In Municipal Mutual Insurance Ltd v. Sea Insurance Co Ltd⁴⁷, reinsurers issued facultative excess of loss

reinsurances covering legal liability policies which the reinsured had issued to a port authority. This authority was held liable to compensate the owners of machinery which had been stored at the port. Over the course of a period of approximately 18 months, the machinery had been extensively damaged as the result of a succession of individual acts of vandalism. It was impossible to say which of these acts on its own caused loss exceeding the excess point under the reinsurance contract.

The judge hearing the trial of the original claim by the machinery owners against the port authority held that most of the damage probably occurred between March 1987 and September 1988 which timespan straddled three successive annual reinsurance contracts. When MMI indemnified the port authority it did not allocate any particular part of that claim to any of the three relevant insurance periods as the total indemnity was within the annual policy limit applicable. For the reinsurances, however, an allocation was necessary as each contract was subject to a substantial excess. Further the identities and subscriptions of the reinsurers varied from year to year.

The reinsured's attempt to allocate all the losses to the 1988 year of reinsurance was rejected by the Court which held that a reinsured could recover in any one year of reinsurance only by demonstrating that the losses fell within that year. As it could not definitely be shown in which year the losses fell, it was held that the appropriate response was to assume a regular and linear pattern of losses. This meant that losses occurring over an 18 month period were to be treated as occurring equally over that period, so that one-sixth of the losses were allocated to 1987, two-thirds to 1988 and one-sixth to 1989.

A similar philosophy of approach has been adopted in **Equitas Limited v R&Q Reinsurance Company (UK) Limited**.⁴⁸ Equitas (as assignee of certain Lloyd's syndicates) sought to recover losses resulting from the Exxon Valdez disaster and the Iraqi invasion of Kuwait. Each of these claims had been the subject of separate litigation and it had been found respectively that part of the Exxon Valdez claims were not covered and the Kuwait claims had been wrongly aggregated. The losses had, before reaching the reinsurances in question, been presented through a long chain of covers up the LMX spiral such that it was impossible to reconstruct the facts without the introduction of the wrongly aggregated and irrecoverable elements. Reinsurers argued that Equitas could not recover anything since it could not prove that the sums claimed were properly due. Many of the relevant reinsurance contracts contained settlements clauses with provisions that the settlements were to

⁴⁷ [1998] Lloyd's Rep IR 421 (CA).

⁴⁸ [2009] EWHC 2787.

be within the terms of the insurance and reinsurance contracts.

Equitas was allowed to succeed by proving their loss using actuarial modelling and giving appropriate discounts to strip out the wrongly aggregated and irrecoverable elements. The court's reasoning was that the reinsured had to prove that the claims were within the terms of the original and reinsurance contracts as a matter of law. The method, however, by which the proof could be provided was not limited to having accurately to reconstruct the claims through the LMX spiral; it was permissible to use actuarial modelling.

A similar approach has since been taken in **IRB Brasil Resseguros SA v CX Reinsurance Company Ltd.**⁴⁹

The trend has therefore been for the English court to take a pragmatic approach to allocation in circumstances where it is clear that there is liability under the reinsurance contracts but the extent of liability is problematic to prove. The court has, however, consistently been clear that this does not mean that the scope of the reinsurance cover can be extended beyond what was originally agreed to be covered. Thus although it was canvassed in a recent case⁵⁰ before a first instance court that there was under English law a general principle that a reinsured could allocate losses so as to maximise recovery under its reinsurance, the judge expressed doubts if this were the case in law.

The United States has a different approach relying upon good faith of the reinsured. There have been several decisions by US courts in recent years addressing the application of the follow the settlements doctrine to reinsureds' post-settlement allocations particularly where the allocations diverge from positions taken by a reinsured during the course of the underlying litigation and where there is an attempt by the reinsured to maximize reinsurance recovery. For the most part, the courts have been highly deferential to the reinsureds' allocations in order to avoid "intrusive factual enquiries into the settlement process" that would undermine the foundation of the reinsured/reinsurer relationship.⁵¹

The well established US view is that the follow the settlements doctrine applies to a reinsured's post-settlement allocations.⁵² The 3rd Circuit Court of Appeal recently

⁴⁹ [2010] EWHC 974 (Comm); 2010 WL 1639729.

⁵⁰ *Teal Assurance Company Limited v. WR Berkley Insurance (Europe) Limited, Aspen Insurance UK Limited* [2011] EWHC 91.

⁵¹ See, e.g., *N. River Ins. Co. v. ACE Am. Reins. Co.*, 361 F.3d 134, 140–41 (2d Cir. 2004).

⁵² *Travelers Cas & Sur. Co. v. Ins. Co. of North Am.*, 609 F.3d 143, 158 (3d Cir. 2010), citing *Travelers Cas. & Sur. Co. v. Gerling Global Reins. Corp. of Am.*, 419 F.3d 181, 188–89 (2d Cir. 2005); *N. River Ins. Co. v. ACE Am. Reins. Co.*, 361 F.3d 134, 140–41 (2d Cir. 2004); *Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. Am.*

articulated the deferential standards that had been applied by most of the courts that have addressed the issue:

"[A]pplying the follow-the-[fortunes] doctrine to post-settlement allocation decisions does not leave a reinsurer without protection. Those allocations must still have been in "good faith" to be binding on the reinsurer. We have broadly characterized the insurer's duty of good faith to its reinsurer as a duty not to take advantage of the reinsurer's dependence on the decisions made by the insurer. In the post-settlement allocation context, this means that an insurer breaches this duty when it makes allocation decisions primarily for the purpose of increasing its reinsurance recovery..."

We make clear, however, that the insurer's negative duty not to make allocation decisions primarily in order to increase reinsurance recovery does not translate into a positive duty on the part of the insurer to minimize its reinsurance recovery. What this means for the reinsurer's burden of persuasion is that, to establish a breach of the duty of good faith, it is not sufficient simply to demonstrate that a particular allocation decision increased the insurer's access to reinsurance, at least not where the insurer is able to point to some legitimate (*i.e.*, non-reinsurance-related) reason for the challenged decision. To prevail, the reinsurer must either provide direct evidence that the insurer was motivated primarily by reinsurance considerations, or show that the after-the-fact rationales offered by the insurer are not credible."⁵³

In the seminal *North River Case*⁵⁴ the court affirmed summary judgment in favour of a reinsured which had allocated an asbestos-related settlement so that it fell entirely on a second layer of reinsurance despite the reinsured's pre-settlement analysis that a settlement would be shared by higher layers of reinsurance. In **Travelers Cas. & Sur. Co. v. Gerling Global Reins. Corp**⁵⁵ the court affirmed summary judgment in favour of a reinsured in allocating an asbestos-related settlement as a single occurrence where the settlement agreement was silent to the number of occurrences and the single occurrence increased the reinsured's reinsurance recovery.⁵⁶

Re-Ins. Co., 441 F.Supp.2d 646, 652–53 (S.D.N.Y. 2006); *Comm. Union Ins. Co. v. Seven Provinces Ins. Co.*, 9 F.Supp.2d 49, 67–68 (D.Mass. 1998).

⁵³ *Travelers Cas.*, 609 F.3d at 158–59 (internal citations omitted).

⁵⁴ *N. River Ins. Co. v. ACE Am. Reins. Co.*, 361 F.3d 134 (2d Cir. 2004).

⁵⁵ *Travelers Cas. & Sur. Co. v. Gerling Global Reins. Corp. of Am.*, 419 F.3d 181 (2d Cir. 2005).

⁵⁶ See *id.*, 419 F.3d 189 ("Given that Travelers and OCF expressly declined to resolve the occurrence issue, there is no

In a further Travelers case⁵⁷, the reinsured entered into an agreement with its insured, Acme, to pay USD137 million to settle breast implant products claims, USD80 million of which was then allocated in the settlement agreement to the breast implant claims. During negotiations, reinsured's in-house counsel prepared a memorandum analyzing reinsurance implications of different scenarios, concluding that treating the breast implant claims as a single occurrence would increase reinsurance recovery, that collection from reinsurers would be more difficult if treated as a single occurrence, but that reinsured's position in arbitration with its reinsurers would be stronger if Acme agreed to a single occurrence agreement in the settlement. At reinsured's insistence Acme acceded to a single occurrence in the agreement. Post settlement, the reinsured allocated a portion of the settlement to two policies with three year coverage periods annualizing the pre-occurrence limits thereby tripling the amount allocated to reinsurers. Two trials then followed. In the first trial, the court rejected reinsurer's argument that the reinsured had improperly manipulated its allocation and found that the reinsured's allocation was reasonable, businesslike and in good faith. In the second trial when the court reviewed the specific direct policies at issue under Michigan law, it determined that the policies clearly and unambiguously provided for a single per occurrence limit for each of two three year policy terms and that the reinsured therefore could not annualize the settlement and tap six per occurrence limits. This had the effect of significantly reducing the reinsurer's exposure.

Although these decisions suggest that reinsureds have wide latitude to allocate settlements to their reinsurers, there are limits and the follow the settlements doctrine may not expand the scope of coverage agreed by the reinsurer. The recent decision **All State Ins. Co. v Am Assur. Co.**⁵⁸ further lends support to the limits:

"The follow-the-fortunes doctrine was intended to foster consistency in the treatment of losses at both levels, insured and reinsured, not to allow an insurer to use a different set of rules at each level. We soundly reject the notion that the follow-the-fortunes doctrine requires that courts turn a blind eye to such manifest manipulation of the allocation process in total disregard of the reinsured's obligation to act in good faith."⁵⁹

cause for us to do so now. Indeed, were we to undertake such an analysis, we would be engaging in precisely the kind of 'intrusive factual inquiry' that the follow-the-fortunes doctrine is meant to avoid.")

⁵⁷ *Travelers Cas & Sur. Co. v. Ins. Co. of N. Am.*, 609 F.3d 143 (3d Cir. 2010).

⁵⁸ 43 A.D.3d 113, 837 N.Y.S.2d 138 (Sup. Ct. App. 2007).

⁵⁹ *Id.*, 43 A.D.3d at 120, 837 N.Y.S.2d at 143.

In German law there is no direct answer to what the position is where the allocation of settlements differs from the basis upon which a reinsured has settled and is now presenting to the reinsurer. The law on direct insurance could provide an answer⁶⁰ but the VVG is not applicable to reinsurance.⁶¹ Gerathewohl⁶² argues in favour of the analogy of the VVG when the general rules of reinsurance do not provide the solution. The prevailing opinion would however be against such an analogy.⁶³ Under the civil law if a reinsurer paid a claim which was stated incorrectly then the reinsurer could rescind the settlement⁶⁴ and claim the money back under the rules of unjust enrichment.⁶⁵ If the reinsured acted fraudulently, the reinsurer could avoid settlement.⁶⁶ If there was negligent breach of the reinsurance contract, the reinsurer would be entitled to damages. If however the allocation was made in good faith then the reinsurer probably has no claim and must follow the allocation.

7. CONCLUSION

The questions posed above illustrate the tensions there are between reinsured and reinsurer. The positions in the three jurisdictions discussed and compared show both important similarities and differences. Both in England and the United States there is case law which has developed the legal position further than in Germany; the paucity of case law in the latter can be said to lead to less certainty (the position is similar in another important reinsurance jurisdiction, Switzerland). Reinsurance being an international business has the difficulty often of different laws applying to both direct insurance and reinsurance contracts; this also makes harmonisation and interpretation less easy. English (and American) case law is reported to be often relied upon in reinsurance arbitrations in other jurisdictions⁶⁷. No doubt there will be further interesting legal developments relating to these important aspects of reinsurance law in different jurisdictions in the years to come.

⁶⁰ Para 28 VVG

⁶¹ Para 209 VVG

⁶² Chapter 7, 2.2.1.1.1.

⁶³ Schwepcke, "Rückversicherung" in *Münchener Kommentar VVG*, 13; Prölss/Martin. VVG para 116 VVG a, F, 2

⁶⁴ Para 119 BGB

⁶⁵ Paras 812 et seq. BGB.

⁶⁶ Para 123 BGB

⁶⁷ The AIDA Reinsurance Working Party's main project is the comparative study of legal issues relating to reinsurance in different jurisdictions – see www.AIDA.org.uk