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Welcome To Our First Issue

We are pleased to introduce Lord Bissell & Brook's inaugural edition of its quarterly reinsurance newsletter. Our Newsletter reflects Lord Bissell & Brook's premier expertise in reinsurance litigation and dispute resolution, transactional and regulatory work. We will provide you with analyses of recent legal decisions, updates on regulatory and legislative developments, and notice of professional conferences and articles. We will also pro-

vide you with our *Client Alerts* on significant and fast-breaking developments for the reinsurance industry. With more than 50 attorneys who specialize in reinsurance, Lord Bissell & Brook is uniquely situated to bring you a full range of informative and timely news. We welcome your comments and suggestions.

Cedents Cannot Require Reinsurers To Pay Litigation Expenses In Excess Of Limits

Once a reinsurer of property insurance has paid the maximum limit stated in the contract, is it further obligated to pay loss adjustment expenses? According to the New York Court of Appeals' recent decision in *Excess Ins. Co. v. Factory Mutual Ins. Co.*, 3 N.Y.3d 577 (N.Y. 2004), the answer is no.

CEDENT SOUGHT \$5 MILLION IN EXPENSES BEYOND \$7 MILLION REINSURANCE LIMIT

Factory Mutual Insurance Company ("FM") issued coverage to Bull Data Systems, Inc. to provide property insurance coverage against the risk of loss or damage to Bull Data's computer inventory stored in a warehouse located in France. FM obtained facultative reinsurance coverage on the risk from various reinsurers, including Excess Insurance Company, Ltd. The terms of the reinsurance contract with Excess set forth a limit of \$7 million per occurrence. The reinsurance contract also listed "conditions," including that "Reinsurers agree to follow the settlements of the Reassured in all respects and to bear their proportion of any expenses incurred, whether legal or otherwise, in the investigation and defense of any claim hereunder."

In June 1991, fire destroyed the insured warehouse, and Bull Data presented FM with a claim for substantial losses. FM defended the claim, primarily on the grounds of alleged arson, incurring approximately \$35 million in litigation expenses.

Ultimately, FM settled the claim for \$100 million. FM sought payment from Excess for not only the limits of the reinsurance contract (\$7 million), but also its proportionate share of the litigation expenses (\$5 million). The trial court granted FM's motion for summary judgment as to the expenses in excess of the contract limits, but the appellate court reversed in favor of the reinsurer.

RECOVERY OF EXPENSES IN EXCESS OF CONTRACT LIMIT DENIED

In considering FM's claim, the New York court reiterated the general principle that in interpreting reinsurance contracts the intention of the parties should control. The court noted that the parties bargained for a contract limit of \$7 million per occurrence, holding:

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Follow-The-Allocation

The concept that the “follow-the-settlements” obligation in some reinsurance contracts extends to a cedent’s post-settlement reinsurance allocation has received a great deal of attention during the past few years, chiefly because of the *Seven Provinces* decision¹ handed down by a Massachusetts federal judge in 1998. Two more recent decisions however, the *North River v. ACE* decision by the Second Circuit Court of Appeals and the *Travelers v. Gerling* decision currently on appeal before the Second Circuit, provide a more meaningful debate on “follow-the-allocation.”

In *North River Ins. Co. v. ACE American Reinsurance Co.* (“*North River*”),² North River issued substantial per occurrence/aggregate limits to Owens Corning Fiberglas (“OCF”) in the second, third, fourth and fifth excess layers. OCF exhausted North River’s products limits but then asserted that certain asbestos claims were not barred by the exhaustion because they were not products liability claims. The parties engaged in ADR proceedings that eventually concluded with a \$335 million policy buyback.

In its reinsurance allocation, North River allocated 1 percent of the settlement to the policy buyback and spread that 1 percent to all its policies in proportion to the policy limits. North River designated the remaining 99 percent (*i.e.*, \$331,650,000) as asbestos non-products and allocated it according to the so-called “rising bathtub” approach. Under this methodology, the entire asbestos non-products loss was allocated to North River’s second layer

excess policies.

Reinsurer ACE, a facultative reinsurer of North River’s second layer policies, argued that North River should have allocated substantially more of the asbestos non-products losses to the higher-layer policies. ACE noted that North River’s pre-settlement analysis of its potential exposure identified risks of loss in those higher layers.

The U.S. District Court for the Southern District of New York adopted the rationale of *Seven Provinces* and granted summary judgment in favor of North River.³ ACE appealed to the U.S. Court of Appeals for the Second Circuit. The Court of Appeals affirmed.⁴ In rejecting ACE’s allocation argument, the Court of Appeals observed that:

Requiring post-settlement allocation to match pre-settlement analysis would permit a reinsurer, and require the courts, to intensely scrutinize the specific factual information informing settlement negotiations, and would undermine the certainty that

the general application of the doctrine to settlement decisions creates.⁵

[T]he court holds that the follow-the-settlements doctrine extends to a cedent’s post-settlement deci-

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[T]he parties negotiated an indemnity limit of \$7 million per occurrence. Thus any obligation on the part of the reinsurers to reimburse Factory Mutual, whether it be for settling the original insurance claim with Bull Data or for the loss adjustment expenses incurred in the protracted litigation that ensued, must be capped by the negotiated limit under the policy. Otherwise the reinsurers would be subject to limitless liability.

The court further noted that nothing in the “follow the settlements” clause of the contract supplanted the liability cap. The court was also motivated by the fact that FM sought to saddle its reinsurers with a litigation bill that exceeded the contract limits by more than 70 percent. The court found that this tactic was particularly unfair, given that the reinsurers had “no control over the management of the unsuccessful litigation that FM launched against Bull Data and no voice in limiting the \$35 million litigation expense.”

Finally, the court rejected FM’s argument that *Bellefonte Reinsurance Company v. Aetna Casualty and Surety Company*, 903 F.2d

910 (2d Cir. 1990) does not control for property insurance. FM argued that liability insurance limits normally already encompass litigation costs, while property insurance limits do not. The court disagreed, reasoning that a contract limit is intended to cap total exposure, and that “reinsurers of property insurance have the same interest in controlling their maximum exposure as do reinsurers of liability insurance policies.” The court further noted that if FM wanted coverage for its litigation expenses, nothing prevented it from including an express provision to that effect in the reinsurance contract.

Factory Mutual will be an important tool for reinsurers seeking to limit coverage to contract limits and for negotiating contract language intended to preclude additional recovery. Cedents may rely on the principles voiced by the dissent to seek such recovery in other jurisdictions, but *Factory Mutual* predicts an uphill battle.

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