Crowell

Client Alert

New York District Court Finds Follow-the-Fortunes and Follow-the-Settlements Are Not Implied in Facultative Certificates

April 5, 2019

On March 29, 2019, following a ten-day bench trial, the federal district court for the Northern District of New York held that neither follow the fortunes nor follow the settlements was implicit in facultative certificates issued in the mid to late 1970s and that the ceding company had failed to sustain its burden to prove that it was "legally obligated" under its policies to pay the expenses it sought to recover from Munich. *Utica Mutual Insurance Company v. Munich Reinsurance America, Inc.*, 2019 WL 1427427 (N.D.N.Y. Mar. 29, 2019). The court also ruled that Munich Re had no independent obligation to pay defense expenses or declaratory judgment expenses under the terms of the facultative certificates.

Utica issued primary and umbrella policies to Gould Pumps. Munich Re facultatively reinsured two of Utica's umbrella policies. Utica's umbrella policies contained a supplemental defense obligation which required Utica to pay defense costs "with respect to any occurrence not covered by the underlying policy(ies)." Utica determined that provision obligated it to pay defense costs once the underlying primary policies were exhausted, and billed Munich Re under its certificates for those amounts in addition to the limits of the facultative certificates. Munich Re initially paid expenses billed under one of its certificates, but, after obtaining additional information about the reinsured policies, took the position that the "occurrence not covered by" language in the Utica umbrella policy means an occurrence "not within the scope of coverage provided by" the policy, and does not provide coverage merely because the primary policies were exhausted, and, thus, in that respect, no longer provided coverage. Accordingly, because Utica's supplemental defense obligation under the umbrella policies was never triggered, Utica was not "legally obligated to pay" defense costs and, accordingly, Munich Re was not liable to pay such costs under its facultative certificates.

Litigation ensued, and the court addressed several important and interesting issues.

Utica's threshold argument was that, even though the Munich Re certificates did not contain a follow the fortunes or follow the settlements provision, those obligations "were, at the time the parties agreed to the Certificates, so 'fixed and invariable' in the reinsurance industry as to be part of the Certificates." Utica sought to make that showing by proffering expert testimony about "the custom and practice in the industry." The court was not convinced, finding that, at best, the expert testimony was credible only "to the extent that it shows that cedents and their reinsurers, in general, endeavor to work together and that reinsurers, whenever possible, will defer to reasonable determinations by cedents in interpreting policies and paying or settling claims." The court noted that Utica's experts acknowledged that "not all reinsurers included these provisions in their reinsurance certificates," and that there were often "reasons why a reinsurance company might not want a follow-the-fortunes or follow-the-settlements provision in its certificate, including the concern 'that the clause itself would create some direct privity of the reinsurer to the underlying insured,' or that the provision might require it to

reinsure 'some kind of ex gratia or business risk kind of payment.'" Accordingly, the court found that "Utica has failed to prove that follow the fortunes or follow the settlements was so fixed and invariable at the time the parties agreed to the [facultative] Certificate that it is implied in their agreement." As a result, the court held that Munich Re was obligated to indemnify Utica only "according to Utica's proven liability on the umbrella policies," and that Utica bore the burden of proving "that it was liable for the defense expenses under the" reinsured umbrella policies.

The court found that Utica failed to meet that burden. Finding the umbrella policies' supplemental defense obligation – which provided defense costs for any "occurrence not covered by" the underlying primary policy – unambiguous, the court held that the provision is triggered only where the occurrence does not fall within the scope of coverage of the underlying policy "and that it does not include exhaustion of [Utica's] Primary here." The court followed the decisions of "the majority of courts" that have addressed "the 'not covered' or 'occurrence not covered by' language," finding that such language unambiguously "refers to the type of risk, not exhaustion or collectability." Because it was undisputed that Utica's primary policies covered the Goulds asbestos losses, the supplemental defense obligation contained in Utica's umbrella policies simply was never triggered. Because Utica was not legally obligated to pay those defense costs under its umbrella policies, Munich Re was not liable for those costs under the certificates.

Utica also argued that, even if its umbrella policies did not "legally obligate" it to pay defense expenses on behalf of Goulds, the certificates nevertheless imposed on Munich Re an independent obligation to pay both defense costs and declaratory judgment expenses incurred by Utica. Utica relied on a provision in the certificates providing that Munich Re "shall be liable for its proportion of allocated loss expenses incurred by the Company." The court rejected that argument and found Utica's interpretation unreasonable. According to the court, "the nature of facultative [re]insurance" is "to reinsure a cedent's risk," and the certificates themselves provided that Munich Re would be "liable" only for losses expenses that were "incurred" by Utica. Under applicable law, "incurred" means "liable for or subject to" and, accordingly, "Utica would not be 'legally liable to pay' Goulds' defense expenses unless the Umbrella policy required it." Since the Utica umbrella policy did not require payment of those expenses, Munich Re was not liable for them under the certificates.

Finally, the court held that the certificates' definition of "allocated loss expense" was "unambiguous and does not include the declaratory judgment expenses here." The court noted that "to be an 'allocated loss expense,' an expense must be allocable to a loss claim that Utica was obligated to pay as a result of an occurrence under the [Utica umbrella policy], i.e., in connection with a particular asbestos claim or suit." Utica failed to proffer any such evidence and, to the contrary, the court noted that "indeed, the declaratory judgment actions primarily involved issues concerning the primary policies, orphan shares and control of the defense: such expenses could not be allocated to the payment of a loss under the [Utica umbrella policy]." (The court also found that New York's "voluntary payment" doctrine precluded Munich Re from recovering any expenses it previously paid under the certificates because Munich Re paid the expense billings "[h]aving full knowledge that it was being billed for expenses on an expense-supplemental basis and that the documentation Utica had provided did not support its expenses supplemental position.")

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

Harry P. Cohen
Partner – New York
Phone: +1.212.803.4044
Email: hcohen@crowell.com

Michael K. Robles
Partner – New York
Phone: +1.212.803.4035
Email: mrobles@crowell.com

Kelly H. Tsai
Senior Counsel – New York
Phone: +1.212.803.4069
Email: ktsai@crowell.com

Brian J. O'Sullivan
Senior Counsel – New York
Phone: +1.212.803.4056
Email: bosullivan@crowell.com