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Follow the Settlements and Allocation after *USF&G v. American Re*... The "Objectively Reasonable" Standard

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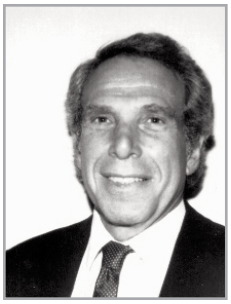

Eugene Wollan

editor's comments

At last! I have been agitating for some time to elicit Letters to the Editor from our readership, and now we finally have one. Dick White's note is, I hope, just the beginning.

Mea Culpa Department: in our last issue there was a typo that I failed to catch. I share the blame with many others, however, who also proofread (or were supposed to proofread) the semi-final version. In my article discussing the unfortunate ubiquity of phrases like, "He gave copies of the exhibits to George and I," I made the point that, contrary to what many folks seem to believe, "me" is not always or necessarily a dirty word. The problem is that "dirty" came out "duty." That's bad enough. What's even worse, however, is that of all the readers who should or could have caught it – ARIAS Editorial Board, CINN staff, innumerable ARIAS members — the only individual who caught it, or at least pointed it out, was my wife. This of course led me inevitably to the speculation that she may be the only person in the world who actually reads my stuff! Is that spousal privilege or marital devotion?

Our lead article in this issue, by Charles Scibetta, is a comprehensive and invaluable analysis of a very recent New York Court of Appeals decision on the super-hot subject of the extent to which a reinsurer is required to accept its cedent's allocation of the underlying settlement. It would behoove us all to be up to date on this subject.

Another topic that seems to be assuming increasing significance is the awarding of interim security. Walter Andrews and Sergio Oehninger have provided a valuable and very readable analysis.

Larry Schiffer, who as we all know could probably moonlight successfully as a computer geek if he weren't busy being a reinsurance lawyer, offers a "Primer" on technology in reinsurance arbitrations. Even though I think of myself as technologically challenged, a good deal of his discussion actually hit home with me.

This issue is so loaded with good, meaty material that we don't actually have room for the usual Law Committee case notes that appear in alternate issues. The notes can, of course, be found on the ARIAS website, and in any event the deviation is only temporary.

By the time you read this, the 2013 Spring Conference will have receded into memory. We hope the memories are pleasant ones for those who attended, and sources of envy for those who didn't!

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Editorial Policy

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All contributions must be double-spaced electronic files in Microsoft Word or rich text format, with all references and footnotes numbered consecutively. The text supplied must contain all editorial revisions. Please include also a brief biographical statement and a portrait-style photograph in electronic form.

Manuscripts should be submitted as email attachments to ewollan@moundcotton.com .

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feature

Follow the Settlements and Allocation after *USF&G v. American Re*... The "Objectively Reasonable" Standard


Charles J. Scibetta

Charles J. Scibetta

On February 7, 2013, the New York Court of Appeals ruled in *United States Fidelity & Guaranty Co. v. American Re-Insurance Co.*[ii] ("USF&G"), a closely watched case on follow the settlements. Although the Court narrowed in two respects a summary judgment upholding a ceding company's allocation of a complex asbestos settlement, it nevertheless confirmed – and arguably raised – the high bar that reinsurers face when challenging their cedents' allocation of settlement payments among potentially responsive policies.

Like "almost all courts to consider the question," the Court first confirmed that the follow the settlements doctrine applies not just to a cedent's decision to settle a claim, but also to its allocation of the resulting loss among policies.

New York follows the majority rule: Follow the settlements applies to allocation.

Like "almost all courts to consider the question," the Court first confirmed that the follow the settlements doctrine applies not just to a cedent's decision to settle a claim, but also to its allocation of the resulting loss among policies.[iii] Given the weight and clarity of prior case law that had already applied the doctrine to allocation, the Court's ruling on this point broke little new ground. Still, the ruling is important confirmation that New York follows the majority rule.

The standard of review under follow the settlements is objective, not subjective.

In a more significant development, the Court clarified the standard of review in a follow the settlements analysis. Prior cases recognized that follow the settlements requires broad deference to cedents' claims handling, and courts generally have held that a reinsurer must follow its cedents' "good faith" decisions. Before *USF&G*, however, no court had articulated a clear definition of good faith in the allocation context.

In particular, some courts struggled with the question of whether and to what extent a cedent may consider its reinsurance coverage while making its allocation decisions. Most courts recognized that it was not bad faith for a ceding company to be aware of how an allocation would affect its reinsurance recoveries when it made that allocation. Yet some courts have suggested that it is bad faith for a cedent to use its awareness of reinsurance implications to choose an allocation that maximized reinsurance.[iv]

Arguably, that view is paradoxical. While courts generally have agreed on the need for deference to ceding company decisions and on the importance of streamlining reinsurance collection disputes, the focus by some courts on the ceding companies' subjective state of mind was having the opposite effect. Even in cases where ceding companies' decisions were objectively reasonable, some reinsurers were being allowed to delay payments while they took discovery into – and even sometimes held a trial on – the cedent's subjective motivations. Their objective: To invalidate an objectively reasonable allocation by proving that the ceding company chose that allocation to maximize reinsurance.

In *USF&G*, the Court rejected the subjective bad faith exception to follow the settlements. The Court clarified that the standard of review under follow the settlements is "objective reasonableness" and that the "cedent's motive should generally be unimportant."[v] In fact, the Court expressly held that a cedent can intentionally maximize its reinsurance recovery through its choice of allocation, so long as the cedent could also reasonably have made the chosen allocation in the absence of reinsurance considerations. The Court stated:

> Cedents are not the fiduciaries of reinsurers, and [they] are not required to put the interests of reinsurers ahead of their own. ...

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> When several reasonable allocations are possible, the law ... permits a cedent to choose the one most favorable to itself. ... We think it unrealistic to expect that the cedent will not be guided by its own interests ....[vi]

The Court held that "reasonable" in the allocation context means: "The reinsured's allocation must be one that the parties to the settlement of the underlying insurance claims might reasonably have arrived at in arm's length negotiations if the reinsurance did not exist."[vii]

The Court's application of the objective standard to the cedent's summary judgment motion.

After clarifying that an objective standard applies under follow the settlements, the Court applied that standard to the facts before it to determine whether the trial court properly granted summary judgment upholding the cedent's allocation. The Court focused on three "significant, disputed assumptions underlying [the cedent's] settlement allocation" to determine whether, if reinsurance did not exist, those assumptions "might reasonably have been the basis for an arm's length settlement among the asbestos claimants, [the insured], and [the cedent]."[viii] The disputed assumptions were:

> (1) that all of the settlement amount was attributable to [reinsured] claims within the limits of the [cedent's] policies, and none of it to the [unreinsured] claims that [the cedent] acted in bad faith when it refused to defend [the insured] in asbestos litigation;
>
> (2) that claims by claimants suffering from lung cancer had a value of $200,000 each [an amount that reinsurers claimed maximized reinsurance], while certain other [claims fell well below the reinsurance attachment point]; and
>
> (3) that the [cedent's] entire payment should be attributed to [one policy, when multiple policies were settled].[ix]

As a preliminary matter, the Court made clear that the settlement terms agreed between the cedent and policyholder do not, standing alone, control under the objective reasonableness standard. The Court observed that the "record show[ed] that the allocation [the cedent] used in billing the reinsurers was one that [the cedent] discussed and agreed on in negotiations with [the insured] and the asbestos claimants."[x] The Court further noted the cedent's contention that "this in itself establishe[d] the validity of the allocation." However, the Court rejected the cedent's argument:

> We are reluctant to adopt a rule whereby an insurer could insulate its allocation from challenge by its reinsurer simply by getting its, essentially indifferent, insured to agree to it. ... [I]n many cases claimants and insureds ..., far from being indifferent, will enthusiastically support insurers' efforts to fund a settlement at reinsurers' expense. They will do this for the simple reason that insurers, like everyone else, are apt to be more generous with other people's money than their own. ... [A] cedent's allocation of a settlement for reinsurance purposes will be binding on a reinsurer if, but only if, it is a reasonable allocation, and consistency with the allocation used in settling the underlying claim does not by itself establish reasonableness.[xi]

Because it could not rely solely on the terms of the settlement, the Court examined the other facts in the record with respect to the three disputed elements of the allocation.

Concerning the question of whether the full settlement amount was attributable to claims within the policy limits and none to the bad faith claims, the Court catalogued a series of record facts that could support inferences adverse to the cedent.

Several pieces of evidence supported the inference that the bad faith claims had some settlement value. The cedent had taken a "very aggressive position" in denying that its policies ever existed, only to "abandon[] [that defense] at a late stage of the coverage litigation, in the face of strong proof that coverage existed."[xii] While the cedent had a plausible legal defense to the bad faith claims – *i.e.* that the insured lacked standing under the particular policies in issue – the court presiding over those claims denied the cedent's motion for summary judgment. Thus, the cedent faced "the possibility of a jury verdict – possibly a very large one – ... with the uncertain comfort of having a logically persuasive argument it could assert on appeal."[xiii] Just prior to settlement, the insured demanded $167 million for bad faith liability. Then, following agreement on settlement terms, the cedent and insured sought approval of a plan of reorganization, "partly on the ground that the bad faith claims had significant value" in the settlement.[xiv] The court that supervised and approved the bankruptcy plan observed that the bad faith claims had value to the estate.[xv]

In addition to this evidence suggesting that the bad faith claims had some value, the Court held that the record contained a piece of evidence that could call into question the reasonableness of the settlement amount for lung cancer claims. The Court noted that, "[A]n expert retained by the asbestos claimants estimated [the insured's] liability for each lung cancer claim at $91,174." If the cedent had valued the lung cancer claims at $100,000 or less, there would have been no reinsurance for those claims. Instead, the cedent valued the lung cancer claims at $200,000. The Court observed that "[i]t is unusual for claims to be settled for more than twice what the claimant's expert has asserted they are worth."xvi It said, "A fact finder could conclude that the lung cancer claims were priced at an unreasonably high level, and included value that should have been attributed to the bad faith claims."[xvii]

In light of these record facts – and citing no evidence to contradict them other than the fact that the cedent and insured agreed on the valuations – the Court held that it was "impossible to

conclude, as a matter of law, that parties bargaining at arm's length, in a situation where reinsurance was absent, could reasonably have given no value to the bad faith claims. This issue must be decided at trial."[xviii] The Court did not rank the importance of the various pieces of evidence that supported its decision. Nor did it say whether any of these pieces of evidence would have been sufficient by itself to defeat the cedent's summary judgment motion.

It seems at least arguable, however, that the expert evidence valuing lung cancer claims at less than $100,000 was critical, and that a zero-allocation to bad faith claims with apparent settlement value might not, by itself, preclude summary judgment for a cedent. For example, regardless of whether it has reinsurance, a cedent may well resist attributing settlement payments to bad faith claims because crediting the litigation risk of those claims could increase their strike value to future plaintiffs and their counsel. If a cedent has an objective basis to make payments within policy limits, therefore, it may be justified in paying the claims within the limits in consideration of a release on both the covered claims and on any bad faith exposure. Requiring cedents to expressly credit bad faith exposure in these circumstances would arguably be requiring them to put reinsurers' interests before their own, which the Court expressly held that cedents need not do.

It is a different case, however, if the cedent has no objective explanation for the payments it makes within its policy limits. The Court in *USF&G* appeared to find no evidence in the appellate record that it deemed to be an objective explanation for why the cedent and insured might have agreed to value lung cancer claims at more than the amount reflected in the expert estimate. Clearly, the Court looked for that evidence. Judge Smith, who authored the decision, asked the cedent at oral argument:

> [Y]ou valued the lung cancer ... claims at ... 200,000 .... What about the fact that the plaintiffs' experts' valuations were lower than that? ... Could you address specifically those expert valuations ... how did the valuations come to be higher than the plaintiffs' experts' numbers? ... Is there ... a document before the actual settlement ... that puts a higher value on lung cancer ...? [C]an you cite me to one?[xix]

Apparently, the Court found no such document – at least it cited none in its written decision. It is at least arguable that the lack of that evidence led the Court to conclude that it could not rule for the cedent as a matter of law on the disputed assumption that all of the settlement amount was attributable to claims within the policy limits and none to the bad faith claims. The Court remanded this issue for trial, where presumably the cedent would have further opportunity to explain its valuation.

The Court next assessed the relative valuation of lung cancer claims to the other disease claims that were valued below the reinsurance attachment point of $100,000. The Court observed that any over-valuation of lung cancer claims could reflect an undervaluation of other disease claims below the reinsurance attachment point. The Court cited no evidence to impugn the valuation of those other claims on their own. Under examination was the "relative valuation" of lung cancer and other claims.[xx] Again, the Court's failure to find evidence explaining the lung cancer valuation appeared to be key. The court sent this issue back for trial as well.

Finally, the Court upheld summary judgment on the cedent's decision concerning the last disputed assumption – the allocation of all loss to just one policy year. On that issue, the cedent did not simply rely on its agreement with its insured to support its decision. The Court upheld the allocation to a single policy year because case law at the time of the allocation provided viable arguments for doing so.[xxi]

Applying the objective standard in future cases.

Parties to future allocation disputes should be careful not to read too much into the Court's decision to remand the bad faith and lung cancer valuation issues for trial. Some industry observers have suggested that the Court's remand might reflect a material broadening of the grounds for reinsurer challenges to allocation decisions. And, clearly, the Court rejected the argument that an allocation's consistency with the underlying settlement is, by itself, sufficient to uphold the allocation as a matter of law. However, by rejecting reinsurer challenges to cedents' subjective motives, the *USF&G* decision seems to close more avenues for reinsurer challenge than it opens.

The view that *USF&G* materially widens the range of disputes that should go to trial arguably confuses the tort concept of "reasonableness" as used in negligence cases with the contract principle of "objective reasonableness" applied in *USF&G*. "[N]egligence actions do not ordinarily lend themselves to summary disposition because, even if the parties agree on the facts, the reasonableness of a defendant's conduct is a question for the jury."[xxii] In a follow the settlements context, however, cedents can argue that the "objective reasonableness" of their exercise of contractual discretion should rarely raise a jury question.

Even before *USF&G*, the Court of Appeals had already ruled that reinsurers have "little room" to challenge a cedent's claims handling decisions[xxiii] and that follow the settlements "streamlines the reimbursement process and reduces litigation by preventing a reinsurer from continually challenging the propriety of a reinsured's settlement decisions."[xxiv] Those rulings are inconsistent with the negligence concept of reasonableness, where a trial is ordinarily required.

In *USF&G*, the Court went even further to suggest that trials in allocation disputes should be rare. In discussing its rationale for holding that follow the settlements applies to allocation decisions, the Court made clear that it did so because a contrary rule would "invite long litigation over complex issues that courts may not be well equipped to resolve, creating cost and uncertainty and making the reinsurance market less efficient. . . . Deference to a

cedent's decisions makes for a more orderly and predictable resolution of claims."[xxv] Given the Court's view that lengthy reinsurance disputes damage the market, and that courts are ill-equipped to resolve them, it seems unlikely that the Court's adoption of the objectively reasonable standard signals support for the fact-driven negligence concept of reasonableness.

The better reading of *USF&G* seems to be that in adopting the objective reasonableness standard, the Court was simply making clear its rejection of the subjective bad faith test that some prior courts had approved. The question whether to judge the exercise of contractual discretion by objective or subjective standards is not unique to follow the settlements disputes. As one commentator has explained concerning the judging of contractual discretion under the U.C.C., some published court decisions "consider only whether the [discretion-exercising party's] action was reasonable, commercially reasonable, or justified by a reason within the justifiable expectations of the parties. Some consider whether the discretion-exercising party was motivated by the right kind of reasons."[xxvi] The objective approach is "the better view" because it avoids "the well-known difficulties in proving subjective motivation" and "best accommodates the discretion-exercising party's interest in deference by judge and jury with the other party's interest in nonarbitrary and expectable reasons for exercising discretion."[xxvii] New York law follows this "better rule" as a general contract rule.[xxviii] By adopting the objective reasonableness standard in *USF&G*, the Court simply confirmed that New York law also follows this rule in the follow the settlements context.

Under the objective approach, where the record reflects multiple objective explanations for a party's exercise of its discretion, "the discretion-exercising party, not a judge or jury, is entitled to weigh the competing reasons," and a party acts within its contractual discretion "whenever significant contractually permitted reasons for its actions were available."[xxix] In the follow the settlements context, since a judge or jury is not supposed to weigh the competing explanations for the cedent's claims-handling decisions under the objective test, the cedent should win as a matter of law – i.e., the question should never reach a judge or jury as a trier of fact – whenever the cedent can establish that some objective, contractually permissible explanation for the allocation outcome exists. In other words, if a reasonable judge or jury could reach the conclusion that objective evidence in the record can justify a reasonable cedent's decisions, then a reasonable cedent could also rely on that evidence. The judge or jury need not and should not step in to weigh that evidence against potentially conflicting facts.

The Court's specific definition of an "objectively reasonable" allocation is consistent with this view. When the Court held that an objectively reasonable allocation is one that a cedent and its insured "might reasonably have arrived at ... in arm's length negotiations" if there were no reinsurance, the Court put the focus not on what the cedent and insured actually agreed to, but on whether contractually permissible reasons for arriving at the challenged allocation existed. If contractually permissible reasons existed – regardless of whether or not the cedent considered them – then the allocation decision should be upheld. If the only possible objective explanation for the allocation is consideration of reinsurance, then reinsurers need not follow the allocation.

Future court decisions may further refine the rule stated in *USF&G*, but the Court's express adoption of the objective standard of review under follow the settlements stands as an important clarification of prior law.

i Charles Scibetta is a founding partner of the law firm Chaffetz Lindsey LLP. Chaffetz Lindsey was involved in the appellate proceedings in USF&G as counsel for certain amici curiae.
ii 20 N.Y.3d 407 (2013).
iii *Id.* at 419.
iv *See, e.g., Travelers Cas. and Sur. Co. v. Ins. Co. of N. America*, 609 F.3d 143, 159 (suggesting that an allocation is in bad faith if the cedent "was motivated primarily by reinsurance considerations").
v *Id.* at 421.
vi *Id.*
vii *Id.* at 420.
viii *Id.* at 422.
ix *Id.*
x *Id.* at 421.
xi *Id.* at 421-22 (internal quotation marks and citation omitted).
xii *Id.* at 422-23.
xiii *Id.* at 423.
xiv *Id.* at 424-25.
xv *Id.*
xvi *Id.* at 424.
xvii *Id.*
xviii *Id.* at 425.
xix Transcript of Oral Argument, pp. 51 – 53 (www.nycourts.gov/ctapps/arguments/2013/Jan13/Transcripts/010213-1-Transcript.pdf).
xx *USF&G*, 20 N.Y.3d at 425-26.
xxi In addition to assessing these disputed assumptions, the Court also commented on one other assumption underlying the allocation. The Court stated that "[it] seem[ed] to be undisputed (and in any event, it is clear from the record) that the claims for the most serious disease, mesothelioma, were reasonably valued." *Id.* at 424. The Court did not discuss the evidence that made the reasonableness of this valuation "clear from the record."
xxii *Merkley v. Palmyra-Macedon Cent. School Dist.*, 515 N.Y.S.2d 932, 937-38 (4th Dept. 1987).
xxiii *Unigard Sec. Ins. v. N. River Ins. Co.*, 79 N.Y.2d 576, 583 (1992).
xxiv *Travelers Cas. and Sur. Co. v. Certain Underwriters* at Lloyd's of London, 96 N.Y.2d 583, 596 (2001).
xxv *USF&G*, 20 N.Y.3d at 419 (citations omitted).
xxvi Steven J. Burton, *Good Faith in Articles 1 and 2 of the U.C.C.: The Practice View*, 3 Wm. & Mary L. Rev. 1533, 1561 (1994).
xxvii *Id.* at 1562-63.
xxviii *See, e.g., Moran v. Erk*, 11 N.Y.3d 452 (2008) (examining the dangers posed by intrusive factual inquiries into subjective motives); *Kerns, Inc. v. Wella Corp.*, 114 F.3d 566, 570 (6th Cir. 1997) ("New York follows the rule that, if a party has a contractual right to take an action, the court may not inquire into that party's motive for exercising that right.").
xxix Burton at 1563.

If the only possible objective explanation for the allocation is consideration of reinsurance, then reinsurers need not follow the allocation.