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Reinsurer May Not Challenge Cedent's Allocation Method, State Judge Rules

BOSTON — The "follow the fortunes" doctrine prevents a reinsurer from denying coverage for the settlement of asbestos claims based upon the cedent's decision to allocate the losses using the "bathtub methodology," a Massachusetts state judge has ruled. _Lexington Insurance Co. v. Clearwater Insurance Co._, No. 09-0234 (Mass. Super. Ct., Suffolk Cty.).

On July 26, Suffolk County Superior Court Judge Janet L. Sanders found that the cedent's allocation decision was not unreasonable or made in bad faith and therefore cannot be challenged.

Dresser Industries was named as a defendant in hundreds of thousands of complaints throughout the United States alleging bodily injury or death from exposure to or inhalation of asbestos and/or silica.

In February 2002, Dresser affiliate Harbison-Walker filed a bankruptcy petition in the U.S. Bankruptcy Court for the Western District of Pennsylvania, seeking to discharge its asbestos liabilities. In the bankruptcy proceedings, Harbison-Walker brought a declaratory judgment proceeding against more than 100 insurers, seeking a ruling as to the coverage for all of Dresser's asbestos liability. Dresser, which filed for bankruptcy in 2003, ultimately took over these proceedings.

Among the insurers was Lexington Insurance Co., which had issued Dresser two consecutive excess policies in effect from Nov. 1, 1976, to Nov. 1, 1978.

The Lexington policies were reinsured under facultative treaties issued by Clearwater Insurance Co.'s predecessor, Skandia America Reinsurance Corp. The treaties included a provision stating, "Skandia's liability . . . shall follow the ceding Company's liability in accordance with the terms and conditions of the policy reinsured hereunder except with respect to those terms and/or conditions as may be inconsistent with the terms of this certificate."

In June 2002, the bankruptcy court ordered the parties to mediate their dispute. Dresser estimated that its developing asbestos liabilities would ultimately reach between $2.2 billion and $3.5 billion. Lexington's parent, American International Group Inc., determined that Dresser's liabilities exposed the full limits of coverage by the AIG companies to the probable loss and that the combined coverage limits of $551 million would likely be reached if the claims were resolved through litigation.

The AIG companies and the other insurers formed a Joint Defense Group to negotiate and settle coverage issues. The group retained NERA Economic Consulting to aid negotiations and NERA prepared spreadsheets that attributed dollar amounts to specific insurers and policies relating to Dresser's coverage. In May 2004, the Joint Defense Group reached an agreement in principle on a global settlement with a net present value of $624,984,393 ($742,556,502 payable over six years). AIG's share had a net present value of $173.6 million.

AIG allocated its contribution among its companies' policies using the "bathtub methodology," in which the policies are metaphorically stacked in a bathtub according to their excess layer, while the liability is poured into the tub. Any policies that are "underwater" are paid out to their limit, while policies that are "dry" are not triggered. In AIG's allocation, the Lexington

policies fell beneath the “waterline,” therefore Lexington was liable for the full limits of its policies, totaling $20 million.

Based on this allocation, Lexington paid the full limits under its policies and billed Clearwater for the full $1 million limit for each of the Skandia certificates. Clearwater refused to pay and Lexington filed suit in the Superior Court. The parties cross-moved for summary judgment.

Clearwater argued that AIG should have allocated the loss in accordance with the NERA spreadsheets and that had it done so, the Lexington policies would not have been exhausted. Judge Sanders, however, ruled that the “follow the settlements” provision in the Lexington policies allowed AIG to allocate the loss as it saw fit, as long as there was no gross negligence or bad faith in the allocation.

“Although no Massachusetts appellate court has specifically addressed the doctrine in the context of a Massachusetts contract, courts in many other jurisdictions have adhered to the doctrine, citing the strong policy reasons behind it,” the judge noted. “Some courts have focused on the wording of the reinsurance contract, but have been generous in reading contractual language in a way which incorporates the doctrine.”

Judge Sanders referred to _North River Insurance Co. v. ACE American Reinsurance Co._ (361 F.3d 134 [2nd Cir. 2004]) in which the 2nd Circuit ruled that the reinsurer’s right to second-guess the cedent’s allocation decisions was limited by the follow the settlements doctrine, “which insulates liability determinations from challenge by a reinsurer unless they are fraudulent or in bad faith.” The _North River_ court explained 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.”

“Applying that same reasoning to the instant case, this Court concludes that Clearwater should not be able to second-guess AIG’s allocation decision unless it is otherwise unreasonable and made in bad faith,” Judge Sanders concluded. “The mere inconsistency between the NERA analysis and AIG’s ultimate decision is not enough. Given the total absence of any evidence of bad faith here, AIG’s allocation governs and the Lexington policies were properly paid in full, triggering Clearwater’s obligation to pay its share.”

Lexington was represented by Peter Chaffetz, Cia Moss and Karen Baswell of Chaffetz Lindsey LLP in New York and by Kim Marrkand and Nicholas Cramb of Mintz, Levin, Cohn, Ferris, Glovsky and Popeo in Boston.

Clearwater was represented by Mitchell King and Adam Doherty of Prince Lobel Tye in Boston.