# The Reinsurance Follow the Fortunes Doctrine: Purely Contractual or Always Present?

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The follow the fortunes doctrine (sometimes referred to as follow the settlements) has been an accepted part of many reinsurance relationships for many years. One of the often cited descriptions of the doctrine states that the doctrine

> "binds a reinsurer to accept the cedent's good faith decisions on all things concerning the underlying insurance terms and claims against the underlying insured: coverage, tactics, lawsuits, compromise, resistance or capitulation." This 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." … It is well-established that a follow-the-fortunes doctrine applies to all outcomes, including settlements and judgments.

*N. River Ins. Co. v. Ace Am. Reins. Co.*, 361 F.3d 134, 139-40 (2d Cir. 2004) (alteration in original) (*quoting British Int'l Ins. Co. Ltd v. Seguros La Republica, S.A.*, 342 F.3d 78, 85 (2d Cir 2003) and *Christinia Gen. Ins. Corp. of N.Y. v. Great Am. Ins. Co.*, 979 F.2d 268, 280 (2d Cir. 1992)).

Contractual follow the fortunes provisions may be very simple, such as "liability of the Reinsurer … shall follow that of the Company." *North River Ins. Co.*, 361 F.3d at 137. In other reinsurance agreements the follow the fortunes provision may be substantively similar, but somewhat more detailed, for example: "All claims involving this reinsurance when settled by the Company, shall be binding on the Reinsurer, which shall be abound to pay its portion of such settlements …." *American Bankers Ins. Co. of Fla. v. Northwestern Nat. Ins. Co.*, 198 F.3d 1332, 1334 (11th Cir. 1999).

The main purpose of the doctrine is to prevent reinsurers "from second guessing good-faith settlements and obtaining *de novo* review of judgments of the reinsured's liability to its insured." *National Amer. Ins. Co. of Cal. v. Certain Underwriters at Lloyd's London*, 93 F.3d 529, 535 (9th Cir. 1995) (quoting *N. River Ins. Co. v. CIGNA Reinsur. Co.*, 52 F.3d 1194, 1199 (3d Cir. 1995). The follow the fortunes doctrine therefore tends to reduce reinsurance claims disputes by making the reinsured's loss decision vis-à-vis its insureds binding on its reinsurers.

The doctrine also tends to increase certainty and consistency for a reinsured, ensuring that, absent the applicability of an exception to the doctrine applying, it will be reimbursed by its reinsurers for the loss payments it makes to its insureds. Furthermore, if a reinsured has more

than one reinsurer sharing the risk of a particular loss, whether on a quota share or other basis, the doctrine tends to promote consistency in the loss payment obligations of all of its reinsurers with respect to a particular loss.

Over the years, courts have addressed a number of issues relating to this doctrine, including, for example, whether the doctrine applies to compromise claims decisions as well as to "routine" claims decisions made in the ordinary course of business, whether the doctrine applies to decisions regarding the allocation of losses among multiple reinsurers, and possible exceptions to the doctrine if the losses are not within the scope of coverage or the reinsured did not act in good faith in making its claims decisions.

This article addresses a more basic issue: whether the follow the fortunes doctrine applies to a reinsurance relationship where the reinsurance agreement does not contain a follow the fortunes provision. Put another way, under what circumstances, if any, may a court imply a follow the fortunes provision into a reinsurance relationship when no such provision is present in a reinsurance contract.

Some courts view the follow the fortunes doctrine purely as a matter of contract, and are reticent to imply new terms into a contract. Other courts take the position that the doctrine is so pervasive in the reinsurance practice that it should be implied into all reinsurance contracts, even if the reinsurance contract does not contain such a provision. It is not the purpose of this article to provide an opinion as to which view is the "better view," nor do we provide an exhaustive review of the case law on this issue. Our purpose is to make readers aware of the two different approaches, provide examples of court decisions articulating each approach, and by doing so to increase awareness of the issue and provide some guidance as to how to approach the issue in jurisdictions that take either view, whether you are in favor or not in favor of implying such a provision into a reinsurance contract.

Perhaps not surprisingly, as will be seen, the resolution of this issue in a particular case may depend in large part upon: (1) what state's law governs; and (2) the factual record provided to the court.

## I. The importance of principles of contract interpretation

Reinsurance agreements are contracts. While one might assume that the basic principles of contract interpretation are uniform from one state to the next, such is not the case. The differences are such that one opinion addressing this issue stated that "[w]hether the "follow the fortunes" doctrine may be implied in a contract by reason of custom or policy will vary depending on which state's laws apply to the contract dispute." *North River Ins. Co. v. Employers Reins. Corp.*, 197 F.Supp.2d 972, 986 (S.D. Ohio 2002). To the extent this is true, if in good faith the laws of more than one state may apply to a reinsurance contract, the conflict of law analysis to determine which state's law applies may turn out to be outcome determinative of this issue. The principal points of difference that are relevant with respect to this issue appear to be the role of contract ambiguity and of custom and practice in interpreting contracts.

### A. The four corners rule and narrow contract interpretation

Some states follow the so-called four corners rule of contract interpretation. This rule of contract interpretation states, for example:

> Under Georgia contract law, parol evidence is inadmissible to add to, take from, or vary a written contract. Ga. Code Ann. § 13-2-2(1). Absent ambiguity, the Court need only look within the four corners of the contract to ascertain its terms.

*Employer Reinsur. Corp. v. Laurier Indem. Co.*, 2007 WL 1831775, at *3 (M.D. Fla. Je. 25, 2007) (a United States District Court sitting in Florida applying Georgia law). In such jurisdictions, a finding that a contract is ambiguous based upon the language of the contact itself, without resort to extrinsic evidence, may be a necessary predicate to the consideration of parol evidence for any purpose. In such jurisdictions, evidence of trade custom may be admissible to assist in the interpretation of a contract only if a contract is found to be ambiguous. *Id.* In a jurisdiction following the four corners rule, if a contract is not ambiguous, evidence of custom may be inadmissible as a basis for implying a follow the fortunes provision into a contract that does not contain such a provision.

In *Laurier Indemnity*, the reinsurance contract did not contain a follow the fortunes provision, but the party advocating for the implication of such a provision into the contract contended that "silence on an issue constitutes ambiguity, thus allowing custom and usage to be considered in the construction of the contract." *Id.* Rejecting that approach, the court stated that this view "defies the established law of contracts," and that parol evidence was admissible only "when an express term within the contract remains ambiguous after looking at the four corners of the document …." *Id.* at *4. The court declined to "go outside the laws of contract construction and outside the four corners of an unambiguous contract to add a clause that was not bargained for." *Id.*

A number of other states follow this rule of contract interpretation. *E.g., RJE Corp. v. Northville Industries Corp.*, 329 F.3d 310, 314 (2d Cir. 2003) (applying New York law); *GMC Capital Investments, LLC v. Athenian Venture Partners I, L.P.*, 36 A.3d 776 779-780 (Del. 2012). In states that follow this rule of contract interpretation it seems unlikely that a follow the fortunes provision would be implied into an unambiguous written reinsurance contract, and evidence of custom and practice would not be admissible to support such implication.

The Michigan Court of Appeals, finding no applicable Michigan law respecting the implication of a follow the fortunes provision into a reinsurance contract, followed what it termed general principles of contract interpretation in reversing a trial court's implication of a follow the fortunes provision into a reinsurance agreement that contained no such provision. The court found that introducing a new provision such as follow the fortunes "would be to write a new contract for the parties. This we have no right to do." *Michigan Township Participating Plan v. Federal Insurance Co.*, 233 Mich.App. 422, 592 N.W.2d 760, 765 (Mi. Ct. App. 1999), *quoting Lehr v. Professional Underwriters*, 296 Mich. 693, 697, 296 N.W. 843 (1941). The court found that it was particularly inappropriate to introduce a provision such as this into the

contract since it might change or otherwise affect the very reason for a reinsurance contract, the scope of the indemnification agreement between the reinsured and the reinsurer.

### B. State specific contract interpretation principles

Some opinions permit the implication of a follow the fortunes provision into a reinsurance contract in reliance on a state statute. For example, applying California law, the court in *National American Ins. Co. v. Cal. v. Certain Underwriters at Lloyd's London*, 93 F.3d 529, 537 (9th Cir. 1996) stated that "[o]rdinary rules of construction permit custom and usage evidence 'both to explain the meaning of language and to imply terms, where no contrary intent appears from the terms of the contract.'" The court did not condition this rule upon the finding of an ambiguity in the wording of the contract, and further held that "a reasonable usage may supply an omitted term or otherwise supplement an agreement." *Id.* at 537. This holding was based in part upon Cal. Civ. Code § 1655, which provides that "[s]tipulations which are necessary to make a contract reasonable, or conformable to usage, are implied, in respect to matters concerning which the contract manifests no contrary intention."

The parties had submitted expert and other evidence concerning the follow the fortunes doctrine and the custom and practice of the reinsurance industry. The district court implied such a provision into the reinsurance contract because it "believed National's evidence had not been contradicted…." *Id.* However, upon reviewing the record, the Ninth Circuit found that the factual record was in fact disputed with respect to this issue, so it vacated the ruling for a trial on this issue. This case was dismissed with prejudice immediately after the appeal concluded. Since this ruling is based upon a California statute it may not be directly applicable in other jurisdictions. However, not all opinions applying California law to this issue have cited to this code section.

### C. The role of custom and practice in implying provisions into a reinsurance contract

Some states permit courts to consider evidence of custom and practice to determine whether a contract is ambiguous, and whether terms not specifically bargained for and included in the contract by the parties should be implied into the contract.

For example, in *The American Ins. Co. v. American Re-Ins. Co.*, 2006 WL 3412079 (N.D. Cal. Nov. 27, 2006), the Court was presented with two facultative reinsurance agreements that reinsured fifty percent of two excess liability policies. The insured faced "tens of thousands of lawsuits based on the asbestos it manufactured." Although the excess policies were not directly at issue in the claims lawsuits then pending against the insured, the insured entered into a settlement agreement with the excess insurer "buying back" the excess policies. The excess insurer submitted a claim to its reinsurers for their portion of its settlement with the insured. The reinsurer declined to pay, contending that the excess policies had not been exhausted by the settlement and that the asbestos litigation was excluded from coverage of the underlying policies.

The reinsurance certificates did not contain a follow the fortunes provision, but the reinsured contended that the doctrine should be read into the reinsurance agreements as a matter of law. The court noted that some courts had implied the doctrine into reinsurance contracts "if there was evidence that, contrary to the common law, a custom or usage to 'follow the settlements' existed at the time the contract was entered into and there was no evidence of a contrary intent from the terms of the contract." *Id.* at *4. The parties disputed whether California or Pennsylvania law applied. The court discussed the Ninth Circuit's *National American* opinion, mentioned that the parties had not cited any applicable Pennsylvania law, found that there was no conflict between the law of California and Pennsylvania, purported to apply California law, but instead of following *National American* concluded, without any mention of Cal. Civ. Code § 1655, which was still in force, that "the majority of courts addressing this issue, and the better reasoned opinions, have rejected the proposition that the 'follow the settlements' or 'follow the fortunes' doctrine may be read into every reinsurance policy as a matter of law." *Id.* at *5. This opinion was on motions for summary judgment, and it is not apparent what factual record was before the court with respect to the custom and practice of the reinsurance industry with respect to this issue. Perhaps since the Ninth Circuit had found a disputed issue of fact in the record before it on this issue the court decided to deny the motions for summary judgment on the issue. The parties reached a settlement of this case shortly after this Order was entered, and the case was dismissed without any further development of this issue on the record.

Applying Massachusetts law, based upon a bench trial that included testimony on the custom and practice of the industry, the court in *Trenwick America Reinsur. Corp. v. IRC, Inc.*, 764 F.Supp.2d 274 (D. Mass. 2011) held that found that the follow the fortunes doctrine should be included in the reinsurance relationship of the parties, which was based upon an oral reinsurance agreement. The court found that applicable law did not support the implication of the follow the fortunes doctrine into the relationship without expert testimony on industry custom and usage. The factual record before the court included experts presented by both parties who essentially agreed on this issue, testifying that the doctrine was a customary component of almost every reinsurance agreement or a "core tenet" of the reinsurance business. *Id.* at 297. Furthermore, this oral reinsurance agreement was part of a broader reinsurance program that was documented in a number of reinsurance agreements, all of which contained an express follow the fortunes provision. Thus, the court was presented with a very strong, essentially agreed, factual record supporting the proposition that the follow the fortunes doctrine was an important part of all reinsurance relationships and this reinsurance relationship in particular.

Yet another approach is evident in *North River Ins. Co. v. Employers Reinsur. Corp.*, 197 F.Supp.2d 972 (S.D. Ohio 2002), a court sitting in Ohio applying New Jersey law. The court in that decision held that a follow the fortunes provision should not be implied into every reinsurance agreement as a matter of law, but that, even in the absence of any ambiguity, "evidence of the situation of the parties and the surrounding circumstances and conditions is admissible in aid of interpretation." *Id.* at 988. This principle is somewhat analogous to the principle followed in some states that parol evidence can be considered to determine whether a contract is ambiguous.

The court announced further principles of interpretation:

- Evidence of the intention of the parties is critical, and "intent may not be disregarded to create a new or better contract or to add to, subtract from, modify, or alter any terms of the agreement." *Id.* at 988-89.
- Insurance policies should be interpreted according to their plain and ordinary meaning.
- In the absence of ambiguity a court should not strain to "write for the insured a better policy of insurance than the one purchased" *Id.* at 989.
- Any custom and usage considered by the court must be established by "clear and explicit proof," and must be "clearly established" and known to the parties or so notorious in the trade as to charge them with notice thereof." *Id.*

While the first three principles are fairly common, in one formulation or another, the final principle, concerning the level of proof required, is not so common.

With these legal principles, the court found that the reinsurance agreements did not contain a follow the fortunes provision and were unambiguous. The court then considered evidence of the custom and practice of the industry, and evidence from one of the parties that the reinsurance contract was not intended to contain a follow the fortunes provision. The court concluded that genuine issues of fact existed that precluded it from resolving the issue in the presented summary judgment context.

The case law with respect to this issue may be complicated, and not necessarily consistent, even as to the law of a given state. For example, compare *RJE Corp.* with *Utica Mut. Ins. Co. v. Munich Reinsur. America, Inc.*, 2018 WL 3135847 at *3 (N.D. N.Y. Je. 27, 2018) with respect to the permissibility of the use of parol evidence to interpret an unambiguous contract. The court held a bench trial on the reinsurance dispute in *Utica Mutual* this summer, and as of the writing of this article the court has not rendered a decision. In pre-trial filings, however, the court found that although the reinsurance contracts did not contain a follow the fortunes provision, the court nevertheless was open to considering evidence of custom and practice and an argument that such a provision should be implied into the reinsurance contracts. *Id.* at *2-3.

## CONCLUSION

There is no denying that the follow the fortunes doctrine is an important doctrine in reinsurance relationships. The issue is whether such a provision should be implied into a reinsurance contract when the parties to that contract did not include such a provision in the contract. If the reinsurance contract is unambiguous on its face, should a court consider parol evidence to even explore whether to add an additional provision to the contract that the parties did not agree to include? Does the absence of such a provision in a reinsurance contract itself make the contract ambiguous, or should a court simply accept the proposition that the absence of the provision reflects an agreement by the parties not to include such a provision in that particular reinsurance contract? Should it make a difference if there is a multi-contract reinsurance program, such as that present in *Trenwick America Reinsur. Corp.*, in which a follow

the fortunes provision was present in all of the other reinsurance contracts, suggesting that the omission of the provision in one reinsurance contract was an inadvertent omission? How many, if any, participants in the reinsurance industry do not include express follow the fortunes provisions in reinsurance contracts on the assumption that the doctrine is part of the standard practice of the industry?

Clearly, there is no consensus in the law of the states as to how to resolve this issue. If there is a choice of law dispute with respect to a reinsurance contract, the resolution of that dispute may be determinative of this issue, making the factual and legal development and presentation of the conflict issue to a court or arbitrator potentially critical. If the applicable law permits the introduction of parol evidence, one should consider offering evidence from the individuals who negotiated or drafted the contract as to the intention of the parties to that contract, and expert evidence of the applicable custom and practice of the reinsurance industry. Finally, if a follow the fortunes provision can be implied into a reinsurance contract based upon the custom and practice of the reinsurance industry, what level of proof of custom and practice is required to support such implication? Is the traditional civil predominance of the evidence standard appropriate, or is some heightened level of proof required, such as "clear and explicit" evidence that makes such custom and practice "clearly established" or "notorious" (*N. River Insur. Co.*, 197 F.Supp.2d at 989), or proof that such custom and practice is "fixed and invariable" (*Utica Mut. Ins. Co.* at *3), or some other formulation of a heightened standard of proof?

One final caution. The discussion in this article is based upon various court decisions. Putting aside the possible inconsistency of court rulings with respect to the law of a given state, generally one may depend upon such decisions providing one a reasonable level of guidance with respect to the likely future decisions of courts in such states. That certainty level will decline markedly, however, if a reinsurance dispute goes to arbitration, where custom and practice traditionally plays a larger role in resolving disputes than in court proceedings, and arbitrators are not bound to strictly interpret and enforce contracts. Under the Federal Arbitration Act arbitrators generally have substantial discretion in applying law to facts, and arbitration awards may be confirmed even if a court finds that the arbitrator misapplied applicable law, so long as the arbitral award finds some support in the reinsurance contract and possibly in the custom and practice of the reinsurance industry.

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