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Reinsurer ordered to follow fortunes of cedant

By JOANNE WOJCIK

NEW YORK-A federal appeals court for only the second time has enforced the common law practices of following the fortunes in reinsurance contracts.

The 2nd U.S. Circuit Court of appeals ruling involved marine insurance written by a captive insurer, but it could apply to policyholders with large self-insured retentions that are commercially reinsured.

The ruling "recognizes today's commercial insurance realities of large deductibles and self-insured retentions by taking the logical step of applying the follow-the-fortunes doctrine to them," said Bud London, an attorney with London Fischer in New York, who represented Mentor Insurance Ltd. in the dispute with a reinsurer.

The May 24 decision-Mentor Insurance Co. (U.K.) and Mentor Insurance Ltd. Vs. AIG Oil rig Inc.-affirms a trial court ruling ordering several units of American International Group Inc. to reimburse now-defunct Mentor for a $1 million claim. That claim was paid in connection with the 1980 sinking of an oil drilling vessel owned by the Bermuda insurer's parent, Ocean Drilling & Exploration Co.

A three-judge panel found that these reinsurers, together with American Re-Insurance Co., were wrong to deny coverage to Mentor simply because the oil rig. Ocean Champion, was salvaged and returned to service.

Mentor insured ODECO's deductible on a $22 million excess of $1 million hull policy from Oil Insurance Ltd.

Mentor reinsured all of its 95% participation in the deductible. AIG was designated to set coverage terms and to take the lead in underwriting and handling claims.

AIG also subscribed to 40% of the $950,000 in ceded reinsurance, acting on behalf of New Hampshire Insurance Co., American Home Assurance Co. and National Union Fire Insurance co. of Pittsburgh, Pa. American Re subscribed to 25% and the remainder was ceded to a group of European insurers.

The case arose out of the sinking of the Ocean Champion while it was being towed from an Egyptian shipyard to an offshore drilling location. At issue was whether the rig, which was ultimately salvaged and put back into service was a "total loss."

One day after the sinking, ODECO told OIL, Mentor and AIG of the loss. The following day, Mentor wrote to the intermediary, Those E. Leeds Co. Inc., to notify its reinsurers that the sinking of the Ocean Champion could result in a constructive total loss.

OIL retained loss adjusting firm Rush Johnson & associates Ltd., which also adjusted the deductible coverage.

ODECO's broker, Marsh & McLennan Inc., advised AIG and Mentor in January 1982 that the Ocean Champion was being repaired, that repair costs would exceed the $1 million deductible, and that the OIL policy had already made partial payment net of the deductible.

M&M asked AIG and mentor to pay their limits under the deductible policy, and the insurers promptly remitted $1 million to ODECO on a partial loss basis.

Meanwhile, OIL and ODECO had begun negotiations to settle ODECO's claim under the policy written by OIL, and ODECO ultimately agreed to accept payment on a constructive total loss basis.

In April 1983, ODECO received $18 million from OIL, representing the Ocean Champion's loss value of $22 million less the OIL policy's $1 million deductible and $3 million as the agreed-upon salvage value of the rig.

On Aug. 4, 1983, Mentor sent a notice of reinsurance loss to Leeds, the reinsurance intermediary, describing the Ocean Champion as a constructive total loss. Leeds then notified American Re and AIG that the claim was covered under the reinsurance contract and requested them to pay Mentor.

AIG refused, asserting that because the treaty only paid on a total loss basis and that initial payment had been made on a partial loss basis, it did not have to pay.

Meanwhile, American Re sent a check for its full share of the reinsurance coverage, but Leeds returned it a year later after it became clear the case would remain unresolved for some time. The foreign reinsurers also remitted their share of the coverage, and Leeds placed those funds in an interest-bearing account pending resolution of the dispute.

On March 1, 1985, Mentor sued AIG and American Re in federal court, where admiralty disputes are handled, rather than state court, where insurance cases are usually heard.

AIG denied liability on the grounds that the Ocean Champion claim "was never a constructive, compromised or arranged total loss and was never abandoned to underwriters."

Pretrial discovery took four years, and in

This decision 'reafirms what has been standard operating procedure,' says Jonathon Bank.

1991 a special master found the settlement of the Ocean Champion loss under the OIL policy "triggered the total loss risk ceded to the reinsurers" and that the reinsurers were required to pay. The trial court adopted the special master's findings.

The reinsurers lost again on appeal to the 2nd Circuit. The appeals court found that even though the deductible coverage's reinsurance could only be triggered by a constructive total loss, the magnitude of the loss could not be determined unless the OIL policy were also triggered.

Therefore, in order to follow the fortunes of the deductible coverage, the reinsurers had to also follow the fortunes of the primary policy written by OIL.

"The court ruled that the loss transaction is determined by its bona fide conclusion and not by its initial or original designation," said Mr. London, Mentor's attorney.

This is only the second time a federal appeals court has enforced the follow the fortunes doctrine against a reinsurer, pointed out Mr. London.

Of the four follow the fortunes rulings issued by the federal appeals courts, Mentor is only the second to require reinsurers to follow the fortunes of cedants when cedants makes good faith payment within the scope of insurance coverings, Mr. London explained.

The first such ruling was a 1990 case also in the 2nd Circuit, Unigard Inc. vs. North River Insurance Co. (B1, Sept. 3, 1990). That case has been appealed.

The other two rulings-American Insurance Co. vs. North America Co. for Property Casualty Inc. in 1982 and Bellefonte Reinsurance Co. vs. Aetna Casualty & Surety Co. in 1990-simply recognized the practice, said Mr. London.

Even though the Mentor case involved a reinsurer-insurer dispute, policyholders should be pleased because the decision prevents reinsurers from second-guessing an insurer's claims adjustment practices, said Stephen L. Thomas, a partner with law firm Thomas & Elliot in Los Angeles.

"If it were decided otherwise, insurers would have trouble adjusting losses" without first getting the consent of reinsurers, he said.

Other reinsurance law specialists said the decision is significant because it affirms common reinsurance industry practice.

"This articulates the recognized custom and practice of following the fortunes," observed Jonathan Bank, a partner with Buchalter, Nemer, Fields & Younger in Los Angeles.

"It reaffirms what has been standard operating procedure," he said

The Mentor ruling does not, however, expand reinsurers' obligations, said Frank M. Nicoletti of Ober, Kaler, Grimes & Shriver in New York.

Instead, he said, it merely affirms the ruling in Bellefonte and "follow the fortunes provisions do not change the reinsurance contract, but simply require payment where a cedent's good faith settlement is within the scope of coverage that was reinsured" (B1, May 28, 1990).

Rarely do federal appeals courts devote such time and resources to reinsurance issues as the 2nd Circuit did in its 41-page Mentor ruling.

"It's an extremely thorough, well-reasoned decision written by a judge who is obviously knowledgeable about reinsurance issues," said Barry Ostrager, a partner with Simpson, Thatcher & Bartlett in New York.

Before being appointed to the bench, Judge Dennis G. Jacobs successfully argued the Unigard case before the 2nd Circuit.

Attorneys for the reinsurers could not be reached.

Mentor vs. AIG Oil Rig Inc., U.S. Court of Appeals for the 2nd Circuit, No. 92-7905.