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Travelers V. INA And The Follow-The-Fortunes Doctrine

Law360, New York (August 10, 2010) -- In *Travelers Casualty Co. v. Insurance Co. of North America*, the U.S. Court of Appeals for the Third Circuit confronted the difficult problem of how cedents and reinsurers allocate liabilities across 11 years of coverage and three layers of primary and excess insurance. Not surprisingly, this thorny reinsurance problem began with an equally troubling liability coverage claim.

Travelers' insured faced thousands of injury claims involving breast implants and pesticides. The insured submitted claims under 11 years of primary coverage from 1976 to 1987. The primary policies, referred to as the "AL policies" covered nonproducts claims.

Further, the AL policies were reinsured by the insured's own subsidiary, so nearly all of the liability under the AL policies was borne by the insured. The advantage of the AL policies to the insured was in the area of defense, not indemnity. The AL policies provided the cost of defense outside of the limits, and Travelers could not seek reinsurance from the insured for defense costs unless it paid indemnity dollars toward the claim.

Travelers (through its predecessor Aetna C&S) declined coverage. By 1998 the insured had paid millions in defense, but nothing for indemnity.

Travelers also provided first-layer excess coverage for products claims (the "XS policies") also reinsured by the insured's subsidiary. Above the XS policies was a second excess layer that provided coverage for both products and nonproducts claims. This second excess layer (the "XN policies") was reinsured by Insurance Co. of North America, not the insured's subsidiary.

Travelers entered into settlement talks with the insured in 1996 seeking a coverage-in-place agreement. Initially, Travelers had two objectives. First, it wanted to designate the breast implant cases as products claims (covered by the XS policies), and, second, it wanted an agreement that the breast implant claims arose from a single occurrence.

Travelers was concerned that its exposure would be exponentially greater if each claim was a separate occurrence. The insured rejected Travelers' approach and instead suggested an all-cash net settlement.

Travelers accepted this format and settled all claims for \$137 million. The settlement was net of any retrospective premium or reinsurance obligation of the insured. Travelers wanted specific allocation wording in the settlement. The insured questioned the need for such wording and rejected some of the proposed language.

Ultimately, the settlement stated that the breast implant claims would be treated as nonproducts, single-occurrence claims. Remember, Travelers originally wanted to treat these as product claims.

The parties also agreed that no portion of the settlement would be allocated to the XS policies, all of which were deemed “exhausted” by the settlement.

Travelers allocated the entire breast implant settlement as indemnity dollars under the pre-1983 AL nonproduct policies. After exhausting those policies, Travelers skipped the later AL policies with aggregate limits and the first-layer XS product policies, deeming them exhausted by the settlement.

Travelers then allocated the remainder of the settlement across the second-layer XN policies that covered both product and nonproduct risks. Two of the XN policies provided coverage for a three-year period and contained per-occurrence limits.

Travelers surprisingly allocated a full occurrence limit to each year of the three-year policies rather than one occurrence limit to the entire three-year policy.

Based on its allocation, Travelers determined that INA, the reinsurer of the XN policies, was obligated to indemnify Travelers for \$13,762,395. INA disagreed with the allocation and refused to pay.

Travelers sued INA in the U.S. District Court for the Eastern District of Pennsylvania, and the district court upheld Travelers’ allocation except for the application of a separate occurrence limit to each year of the three-year XN policies.

Both parties appealed. Among other things, INA argued that Travelers logically should have allocated to all 11 years of the AL nonproduct policies and the XS product policies before allocating to the second-level XN policies.

INA accused Travelers of allocating in bad faith to maximize its reinsurance claim. INA pointed to an internal Travelers memorandum discussing how an allocation agreement with the insured would improve Travelers’ reinsurance claim.

For its part, Travelers argued that it was reasonable to allocate three separate occurrence limits to each of the three-year excess policies, while INA claimed such an allocation was simply contrary to the language of the XN policies, which have a single occurrence limit for the entire period.

The district court had concluded that Travelers’ allocation was reasonable because it followed the terms of Travelers’ settlement with the insured.

The appellate court generally agreed with the conclusion but rejected the district court’s reasoning. The Third Circuit was uncomfortable with Travelers’ reliance on allocation language in the settlement agreement with its insured.

The court noted that in this case Travelers’ insured really had no interest in the allocation language.

Having rejected much of the district court’s reasoning, the appellate court nevertheless sustained the district court’s result.

Relying on the principle that the doctrine of “follow the fortunes” applies to post-settlement allocations, the Third Circuit found no bad faith with respect to Travelers’ allocation to the AL and XN policies. The court held that the allocations were reasonable under follow the fortunes and upheld Travelers’ allocation as modified by the district court.

Somewhat troubling is the absence of any discussion about whether the allocation was reasonable under the specific terms of the policies.

INA argued that the settlement “did not alter the basic fact that an insurance policy is only exhausted when money is allocated to it up to the applicable coverage limit.”

But the appellate court rejected INA’s argument, saying: “fortunately for us, we need not wade into this quasimetaphysical debate over what exhausting an insurance policy ‘really’ requires. In this context, it is enough to note that INA has not shown that Travelers’ position is unreasonable.”

The reader is left to wonder if the Third Circuit, unable to negotiate the weeds of allocation on these facts, erred on the side of deference to Travelers’ allocation.

On a clearer issue, the court found that the language of the XN policies plainly provided for a single occurrence limit to be applied once to the entire three-year policy. The court therefore rejected this portion of Travelers’ allocation.

Travelers v. INA suggests that a plausible allocation theory supported by a modicum of industry practice is all that is needed to satisfy a claim for reinsurance. Other cases are to the contrary. As practitioners look to the language of the policy itself and ask if a disputed allocation conflicts with the coverage, they may conclude that absent evidence of bad faith or a clear transgression of the policy terms, the Third Circuit is not eager to overturn a cedent’s allocation.

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The decision discussed in this article dealt with a number of other issues, including choice of law, prejudgment interest and evidentiary rulings. The author has focused solely on the issue of allocation of the breast implant settlement in this article.

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