

**Commentary*****Follow The Fortunes:  
Industry Customs And Practices***

By  
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***Introduction***

The concept underlying the Follow the Fortunes clause is to provide for the efficient spreading of risk among many insurers and reinsurers. Without it the insurance industry would surely have been different: smaller, regionalized, and, possibly, less important. The development and use of the clause beginning in the 1800's has allowed insurers to boldly take on every manner and size of loss exposure and to cost-effectively parcel out smaller shares of that risk to insurers throughout the world.

As it has evolved through industry custom and practice, the clause provides simply that most of the decisions of a company handling claims under an indemnity<sup>1</sup> agreement containing a Follow the Fortunes clause are binding on the insurer. These decisions include the manner of the claim investigation, the amount of the settlement, and coverage decisions. The only exceptions, under custom and practice, are when the claim handler has committed fraud, collusion, or has acted in bad faith or when the claim in question is not even arguably covered under the insurance contract. By taking away the ability of insurers under the clause to contest most claim decisions and results, risk can economically be shared and spread from one insurer to another.

The clause is most commonly found in reinsurance agreements and custom and practice under the clause has developed chiefly in the reinsurance field. Under these indemnity agreements, an insurer (called the cedant, reinsured, or ceding company) transfers all or a part of a risk assumed under a policy or group of policies to another insurer (called the reinsurer.) The clause is sometimes also found in manuscript insurance policies. The concept comes by different names: Follow the Fortunes; Follow the Settlements; Pay as Paid; Loss Settlement.<sup>2</sup> These are words of art describing a long-standing practice and they all have the same meaning in custom and practice.

***Reason For The Clause***

In a reinsurance contract, the ceding company paying the claim wants to be free from the worry that the reinsurer will refuse to pay because it disagrees with the way the

claim was handled or will require a strict proof of every element of the claim. The presence of this clause gives the ceding company wide latitude, safe from the judgmental eye of the reinsurer, in how it investigates, evaluates and resolves claims. The purpose of the clause is to ensure swift, unimpeded reimbursement to the company.

### ***Exceptions To The Rule***

The Follow the Fortunes clause, of course, does not give the cedant free rein. There are limits to the latitude and discretion given the ceding company under the clause. The reinsurer, under custom and practice, is not required to reimburse if there has been fraud, collusion, bad faith or if a claim is not even arguably covered under the reinsured contract.

Fraud and collusion are self-evident exceptions to the general rule. It would be against custom and practice (and public policy) to require payment where a false claim has been submitted or where there has been a conspiracy against the reinsurer. In a way, fraud and collusion are forms of bad faith, but they are traditionally considered separately.

What is bad faith in this context and what does it mean to say that a claim is not even arguably covered?

A. Bad Faith. The claim handler is acting in bad faith, under custom and practice, if its actions are so egregious as to indicate a *de facto* repudiation of the insurance contract. The conduct must demonstrate an abandonment of the ceding company's good faith obligations under the agreement.

1. *Claims Handling.* As an example, it may be bad faith if an insurer's claim department employs minimal and unqualified claim staff to handle an avalanche of cases where lawsuits are regularly going into default. If the claim handling has broken down or is close to it, the cedant may have abandoned its good faith duties under the contract.

At some point the claim handling can cross the border from being poor to being bad faith. At that point, under the practices in the industry, the reinsurer is relieved of its duty to reimburse the ceding company. However, the threshold for the quality of the claim handling is a low one. So long as the cedant has done the basic minimum to investigate, evaluate and resolve the claim, the reinsurer is obliged to pay.

If the reinsurer does not like the quality and results of the claim handling, its remedy is to remove itself from the risk as soon as possible. It cannot refuse to pay the ceding company; it would be the easiest brick to throw to allege that the claim handling is not up to snuff. It would frustrate the principle underlying the Follow the Fortunes clause — ensuring swift, unimpeded reimbursement — for the reinsurer to refuse to make prompt and proper payment because of poor claim handling. But a bad faith breakdown in claims handling would relieve the reinsurer of its obligations to reimburse the cedant.

2. *Coverage Inconsistency.* Another example of possible bad faith in the reinsurance field, can occur when a carrier inconsistently or improperly allocates its dates of loss to maximize its reinsurance recovery. To be sure, it is legitimate for the carrier to seek to maximize its reinsurance recovery. But it is not proper for the carrier to arbitrarily change from claim to claim how it allocates its losses simply to manipulate and increase

reinsurance recoverables. The insurance carrier must be consistent in its allocation methodology, its contract and exclusion interpretations, and let the chips fall where they may on reinsurance recoveries. Otherwise the conduct could amount to bad faith.

B. Not Arguably Covered. Custom and practice dictates that the reinsurer, operating under a Follow the Fortunes clause, is not required to pay on a claim that is not even arguably covered under the reinsured contract. If the loss date occurred or the claim was made before the effective date of the contract then there is no triggered coverage. Or, if the ceding company seeks payment for an airplane crash under an automobile policy, the reinsurer is not required to pay because there is no arguable or colorable basis for coverage to exist.

Must the cedant have a *reasonable* basis for its coverage decision? Many court decisions have held so. The problem with the term "reasonable" is that it conjures up the "reasonable man" standard of conduct found in negligence law. This could imply that there is a single, objective standard for making a coverage decision.

It may also sound perverse to say that there could be many different but reasonable bases for coverage.

But in fact there can be many *reasonable* ways of interpreting coverage, which can lead to opposite results. In the environmental field, for example, the differing trigger of coverage theories of exposure and manifestation come to mind. If the courts have not ruled on a coverage question, then there are only arguments on each side and both could be reasonable.

"Reasonable," in the Follow the Fortunes context, means "sensible," or perhaps more colloquially "not irrational." Under custom and practice, if the ceding company's coverage decision is sensible, not totally unreasonable (i.e. arguable or colorable), then the reinsurer must accept the cedant's judgment. Again, the ceding company must meet a low threshold to satisfy the Follow the Fortunes clause on coverage issues. To do otherwise would frustrate the goal underlying the Follow the Fortunes clause — swift, unimpeded reimbursement to the cedant.

Once the ceding company has adopted a coverage position on an issue it should stick to it unless there is good reason to do otherwise. Taking an inconsistent coverage position on claims with similar facts, especially if it serves to maximize insurance recoveries, may be a warning sign that the cedant is engaging in bad faith.

In the reinsurance field, however, an insurance carrier may initially take a strong "no coverage" position with its policyholder but later abandon that position and settle the claim. If this happens, the reinsurer cannot use the "no coverage" position as a basis for denying the claim, arguing that the carrier has been inconsistent. Carriers regularly posture for settlement purposes; that is normal and expected to happen. The commercial, business decision to change negotiating posture and settle, under custom and practice, is still binding on the reinsurer.

C. Miscellaneous Issues. There are a number of other topics in the reinsurance field that sometimes involve the Follow the Fortunes clause. These are briefly discussed here:

1. *Contract Limits.* Cedants maintain that the reinsurer is required to pay expenses in excess of its contract since this is what custom and practice as well as the Follow the Fortunes clause calls for. Reinsurers argue the clause was fashioned to ensure swift reimbursement, not to increase contract limits.

2. *Declaratory Judgment Expenses.* Cedants often contend that coverage litigation expenses should be reimbursable by reinsurers because the Follow the Fortunes clause binds the reinsurers to all of the decisions of the company's claim handlers. This includes the cedant's decision to contest coverage with the policyholder. Reinsurers contend that these DJ expenses are not an obligation under the policy reinsured and are, therefore, not an obligation of the reinsurer. Instead, they contend that these expenses are incurred to defend the policy contract language and should be considered a general business expense that is partially paid for by the ceding commission.

### ***How Reinsurers Cope With The Clause***

The reason behind the Follow the Fortunes clause is practical and necessary. But, its operation puts the reinsurer in a vulnerable position. In effect, the clause allows the claim handler to make the final decision on how the reinsurer's money is spent and the reinsurer, for the most part, cannot object. The general rule clearly is that the reinsurer must pay the cedant even if the claim handling is sloppy, needs great improvement, is not up to par with everyone else in the industry. The reinsurer must pay even if it believes the settlement was too high or that all of the facts of the claim were not adequately proven. So long as the claim handling is not so poor that it amounts to fraud, collusion, bad faith, or the claim is not even arguably covered under the reinsured contract, the ceding company is entitled to reimbursement.

What are the practices and procedures that reinsurers use to protect themselves under the clause?

- They make an informed decision whether they are comfortable putting their money in the control of the cedant's claim handlers. This is discussed below.
- They ordinarily require in the contract timely and complete notification of serious claims such as those involving severe injuries or with significant reserves above a certain threshold. Most contracts with a Follow the Fortunes clause also contain a Loss Notification clause.
- They periodically visit the ceding company and conduct audits. They review the claim handling operation before, during and after the contract is in effect. Most contracts with a Follow the Fortunes clause also contain an Audit and Inspection clause, which allows the reinsurer to do this. If the reinsurer is bound by the decisions of the cedant, it makes sense it would want to closely monitor and advise the claim handlers.

Prudent reinsurers, especially those subject to a Follow the Fortunes clause, audit in order to:

1. Set their own reserves;
2. Assess the claim department for technical claim handling and management capabilities, practices, procedures and results;
3. Influence claim-handling decisions (most reinsurance contracts have a Right to Associate clause);
4. Strengthen relationships and improve coordination and communication; and,
5. Ensure full disclosure and honesty as well as overall contract compliance.

Audits are conducted before the contract is in effect so the reinsurer can make a due diligence decision whether it wants to be bound by the decisions and actions of the claim handlers. Also, the audits are conducted beforehand to independently assess exposures to help in pricing the contract and to assist in finalizing terms, conditions and exclusions.

Audits are conducted during the contract for all 5 of the reasons given above.

Finally, the claim handlers conduct audits after the contract has expired to evaluate reserve adequacy; to influence litigation and claim management decisions; and to ensure proper communications and full disclosure.

The Audit and Inspection section does not trump the Follow the Fortunes clause. The reinsurer cannot improperly assert the right to audit the ceding company's claims handling and settlements for the purpose of second-guessing, after the fact, what the cedant has done. Most of the ceding company's decisions are binding on the reinsurer, even if the reinsurer disagrees with them.

Conversely, the Follow the Fortunes clause does not take precedence over the Audit and Inspection section. The cedant cannot refuse access to its records by arguing the reinsurer must unilaterally go along with its actions and decisions and there is no demonstrable need to conduct audits. As indicated above, there are many good reasons the reinsurer would want to conduct audits.

Because the reinsurer must, for the most part, go along with the ceding company's actions, it is natural that the reinsurer would want the opportunity to closely follow how the cedant is handling its claims. While the reinsurer has the right to audit, it cannot long delay or resist payment to the ceding company without a compelling reason.

### **Conclusion**

There is sometimes a mystery that surrounds the meaning of the Follow the Fortunes clause and how reinsurers and cedants apply it day to day. The clause uses a few words to identify complex, longstanding rules that have developed through custom and practice. An explanation is needed to understand what practice lies behind those few words.

The mystery is removed if one remembers that the Follow the Fortunes clause is created to allow the *economic* spreading of risk to insurers, reinsurers and their reinsurers. It facilitates this by providing that one and only one claim handler will make most of the management decisions in investigating, evaluating and resolving a claim or a loss.

The clause prevents a chorus of reinsurers from slowing down the process by making onerous objections to specific events and decisions throughout the claim handling. However, it does not preclude reinsurers from making appropriate and timely objections where there is fraud, collusion, bad faith, or the claim is not even arguably covered under the contract.

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## **ENDNOTES**

1. Under an indemnity contract the insured company pays its claims or losses in the first instance and is later reimbursed by its insurer. This is in contrast to a "pay on behalf" contract under which the insurer itself both handles and pays the insured's claims.
2. Examples of the Follow the Fortunes clause are:

The liability of the reinsurers shall follow that of the company in every case and shall be subject in all respects to all of the general and special stipulations, clauses, waivers, and modifications of the company's policy.

All claims involving this reinsurance, when settled by the reinsured, shall be binding on the reinsurer.

The reinsurer shall pay as may be paid by the [insurer]. ■