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The USF&G (Western MacArthur) Case: Key Takeaways

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The final chapter in the long-running dispute between U.S. Fidelity & Guaranty Co. and its reinsurers closed in May when USF&G settled with the last-standing reinsurer regarding its reinsurance billings arising out of its settlement of its coverage obligations for Western MacArthur Co.'s asbestos liabilities.

The litigation lasted 15 years. It involved a nearly billion-dollar underlying settlement as well as hundreds of millions of dollars in reinsurance billings. Not surprisingly, it produced its fair share of notable court rulings.

BACKGROUND

USF&G issued insurance policies to Western MacArthur's predecessor-in-interest, Western Asbestos Co. After individuals brought asbestos claims against Western MacArthur, Western MacArthur sought coverage from USF&G.

USF&G denied coverage.

Western MacArthur then sued USF&G, alleging breach of contract and bad faith. In June 2002 USF&G agreed to pay Western MacArthur more than $975 million to settle their disputes.

Under reinsurance treaties USF&G had purchased, USF&G then billed its reinsurers for about $400 million of the settlement amount.

After the reinsurers requested additional information, USF&G led suit against American Re-Insurance Co. in California federal court, and American Re led suit against USF&G and the other treaty reinsurers in New York state court.

The federal court dismissed the California case. The litigation proceeded in New York, resulting in a variety of rulings.

SUMMARY JUDGMENT RULING

In 2010, the trial court denied the reinsurers' motion for summary judgment and granted summary judgment in favor of USF&G.

Proof of asbestos exposure

One of the reinsurers, American Re-Insurance Co., claimed that its obligations were limited to payments to asbestos claimants for which USF&G could prove exposure to asbestos before 1960, which was the last year in which USF&G insured Western MacArthur, as well as exposure to the asbestos products or operations of Western MacArthur.

The trial court rejected that argument, saying it would require the court "to examine the actual distribution made to particular claimants under the trust distribution procedures, and determine whether the amount actually received by each claimant implicates" the reinsurers' obligations.

It said doing so would contravene the treaty, which "addresse[d] USF&G's losses pursuant to its underlying policy, not the actual recovery by individual claimants as against USF&G's insured."

In any event, the court added, "further inquiry into the actual recovery of each claimant would constitute the kind of relitigation that the follow-the-fortunes doctrine is designed to avoid." Under well-established law, the follow-the-fortunes doctrine generally requires a reinsurer to defer to the cedent's reasonable decisions related to the reinsured policies and underlying claims.

On appeal, the New York Court of Appeals, the state's highest court, did not discuss the trial court's conclusions regarding proof of asbestos exposure. Nonetheless, its decision contains several important aspects.

Post-settlement allocations

The New York Court of Appeals joined the 2nd and 3rd U.S. Circuit Courts of Appeals in finding that the follow-the-settlement doctrine applies to post-settlement allocations.

Thus, when settlement payments are allocated for reinsurance purposes, the follow-the-settlement provision will ordinarily require a reinsurer to defer to that allocation, just like it requires a reinsurer to defer to a cedent's decision to settle or to pay a particular amount to settle.

The state high court noted, however, that deference to a cedent's allocation decisions "is not to say they are immune from scrutiny."

The court stated that the "reinsured's allocation must be one that the parties to the settlement of the underlying insurance claims might reasonably have arrived at in arm's length negotiations if the reinsurance did not exist."

"Objective reasonableness should ordinarily determine the validity of an allocation," the court said. Thus, the cedent's subjective intent is generally "unimportant," and a cedent may choose a reasonable allocation that is "most favorable to itself," it added.

Importantly, the high court ruled that cedents need not ignore their own interests. Moreover, they are not required to "put the interests of reinsurers ahead of their own."

USF&G's allocation

Applying these standards to USF&G's allocation, the New York Court of Appeals upheld summary judgment as to one part of the allocation and reversed it as to another.

USF&G had allocated all of the losses to one of many insurance policies it issued. Even though this allocation worked "to the advantage of USF&G and the disadvantage of the reinsurers," the high court found no evidence suggesting that this aspect of the allocation was unreasonable.

Instead, based on the language of the policies and the case law, the cedent's allocation to one of the insurance policies was reasonable, it said.

However, the court reversed summary judgment with respect to the reasonableness of the cedent's allocation of none of the settlement amount to bad-faith claims and of the values assigned to different types of asbestos claims.

The high court said the following evidence raised an issue of fact:

- USF&G faced a significant risk of an adverse bad-faith verdict, given that it had taken an aggressive position in refusing to admit that it had insured Western MacArthur for asbestos claims and later abandoned that position.
- USF&G inflated values to certain mesothelioma and lung cancer claims.
- USF&G and Western MacArthur "persuaded a bankruptcy court to approve a plan of reorganization based on the settlement, partly on the ground that the bad-faith claims had significant value."
- Western MacArthur's settlement demand shortly before the settlement included a demand of $167 million for the bad-faith claims.

DISCOVERY RULINGS

As expected, the USF&G case also involved its fair share of discovery disputes.

Settlement documents

USF&G objected to producing information about settlement negotiations with Western McArthur.

The intermediate appellate court found that the reinsurers could discover documents relating to the settlement negotiations between USF&G and Western MacArthur. According to the court, that discovery was "material and necessary to the reinsurers' defense of the action."

The follow-the-fortunes doctrine did not foreclose the discovery because the reinsurers had viable claims that exceptions to the doctrine applied.

The appeals court also rejected the argument that any settlement privilege would bar discovery because the reinsurers sought the material "for a purpose other than proving USF&G's liability in the underlying coverage action."

Cedent's privilege assertions

However, in a later decision, the intermediate court largely upheld USF&G's privilege assertions.

It found that the common-interest doctrine did not apply, explaining that "the parties' interests in the present action are indisputably adverse" and that "the mere fact that they shared an interest in the eventual outcome" of the litigation between USF&G and Western MacArthur was "not sufficient to create a common interest so as to defeat USF&G's claims privileges."

That court also found that USF&G's reports to the reinsurers and USF&G's counsel's communications about strategy with the reinsurers during the litigation between USF&G and Western MacArthur did not waive the privilege because USF&G and the reinsurers shared an interest in the outcome of the underlying litigation.

The appeals court also rejected the reinsurers' broad at-issue waiver argument that USF&G placed privileged material at issue by claiming that the settlement and reinsurance bill were made and presented in good faith. "An insurer does not place the bona des of a settlement at issue merely by alleging in a pleading that the settlement was reasonable and in good faith," it said.

The appeals court did find a narrow at-issue waiver based on a witness's testimony about advice he received while preparing the reinsurance bill.

It later clarified that the waiver was limited to communications between one USF&G employee and one USF&G in-house attorney and that the waiver "did not extend to cedent's communications with any other attorneys concerning this subject matter."

MOTIONS IN LIMINE RULINGS

Jury's role

In deciding motions in limine, the trial court ruled that the trial was not an all-or-nothing proposition for USF&G.

Rather, it said that if the jury found USF&G was unreasonable in allocating no part of the settlement to the bad-faith claims, then the jury would determine how much of the settlement USF&G should have allocated to those claims. USF&G's recovery would then be calculated based on the jury's finding.

Post-settlement events

The reinsurers moved to exclude all evidence postdating USF&G's settlement with Western MacArthur.

Based on the Court of Appeals' statement that a reasonable allocation was one that "the parties to the settlement of the underlying insurance claims might reasonably have arrived at in arm's length negotiations if the reinsurance did not exist," those reinsurers argued that "anything postdating the settlement must be on its face irrelevant since it could not have been considered by the settling parties in negotiating the settlement."

The trial court rejected this blanket rule, saying the reinsurers' argument "just didn't make any sense."

Instead, the trial court evaluated the admissibility of post-settlement evidence in the same manner as pre-settlement evidence.

Settlement provisions

The court denied the reinsurers' motion to bar admission of certain provisions in the settlement agreement between USF&G and Western MacArthur.

The court explained that although the mere agreement between USF&G and Western MacArthur was not dispositive of the reinsurers' obligations, the provisions in the agreement were nevertheless "relevant evidence regarding the objective reasonableness of the allocation."

Right to associate
The reinsurers also moved to prohibit USF&G from referring to the reinsurers' right to associate.

USF&G stated that it intended to refer to that right only if the reinsurers argued that USF&G did not keep them informed about the settlement.

Based on prior rulings, the court said that whether USF&G kept the reinsurers informed was not an issue for trial. Because the reinsurers were not going to make the argument in response to which USF&G would introduce this evidence, the trial court denied the reinsurers' motion as premature.

Beside the fact that Jerry Brown was California's governor in 1978, when Prop 13 was passed, and is also governor today, why is Prop 13 relevant again, nearly 40 years after its passage? Because it was at the heart of a legal debate resulting in an April 6, split court of appeals decision upholding California Air Resources Board (ARB)'s cap-and-trade system. This system, implemented by ARB under the authority of the California Global Warming Solutions Act of 2006 (commonly referred to as AB 32), applies an aggregate greenhouse gas (GHG) allowance budget on covered entities and provides a trading mechanism for emission allowances. Covered entities must either reduce their emissions below a threshold point or obtain offset credits or emissions allowances, either from ARB or the open market. While ARB either retains or distributes some of these allowances for free, it auctions the rest periodically. The auction portion of California's cap-and-trade system has been enormously profitable for the state, has raised billions of dollars in revenue since FY2012. Laudable as the projects on which the revenue is being spent may be, e.g., water-energy efficiency programs and the high-speed rail project, the question is whether ARB should be raising money in this manner.

Specifically, plaintiffs (several business organizations and a taxpayer) raised the following issues before California's Third District Court of Appeal in *California Chamber of Commerce v. State Air Resources Board*, Nos. C075930, C075954 (Cal. Ct. App. Apr. 6, 2017):

- Whether ARB exceeded its authority when it created a cap-and-trade system that allowed for auctioning allowances; and

- Whether the revenue generated by the auction sales amounts to a tax that violates the two-thirds supermajority vote requirement of Prop 13.

The court affirmed the lower court and the ARB program 2-1 on both of these issues, over a strongly worded dissent.

On the first issue, the only unanimous aspect of the decision, the court summarily rejected the plaintiffs' argument that the ARB exceeded its statutory authority when it included auctions as part of the cap-and-trade program, concluding that the legislature's 12-page statute vested significant discretion in ARB to craft a system of distributing allowances, including the possibility of auctioning them.

On the second issue, the court considered whether proceeds from the auction sales under the cap-and-trade program implemented under AB 32 were an impermissible tax under Prop 13, since passage of AB

32 did not garner a supermajority. This question required the court to consider the question, what's a tax? California courts have interpreted the word so that it also requires a supermajority for regulatory fees that are in essence taxes, such as when those fees exceed the reasonable cost of providing the funded service or are charged to raise funds for an unrelated purpose.

The majority nevertheless found that the auction portion of the cap-and-trade program is not a tax for two reasons.

- First, the court determined that the decision to purchase greenhouse gas allowances is a voluntary action that is not "compelled" by the government. The majority noted that regulated entities can comply in multiple ways, such as reducing their greenhouse gas emissions below the level covered by their free allowances, earning emission offsets or purchasing allowances or emission offsets from third parties. The majority determined that buying allowances is a business decision, not a requirement, and went on to state that there is no "vested right to pollute in California."

- Second, the majority noted that emission allowances are valuable property interests that may be sold or traded and observed that some have sought to earn a profit by buying allowances. The majority stated that these facts show that the fees paid for allowances are not taxes, since taxes are compulsory and do not provide the payer with an instrument of value in exchange for the tax. Finally, the majority stated that it did not need to evaluate prior precedent regarding when regulatory fees are actually taxes because auctioning allowances is "a different system entirely" than requiring polluters to pay a regulatory fee.

Judge Harry E. Hull dissented from the majority opinion on the second issue. He would have ruled that the auction program does impose a tax because it is a mandatory cost of doing business in California. He pointed to an uncontroverted declaration stating that the plaintiff Morning Star must purchase allowances to cover its emissions. Because Morning Star must bear increased costs to continue doing business in California, purchasing allowances is essentially compulsory and should be considered a tax. Hull also noted that auction proceeds are used in ways that go far beyond covering the costs of administering the program, which also supports the contention that the program is a tax.

At least one of the plaintiffs has reportedly already signaled its intent to appeal the decision to the California Supreme Court. Review by the Supreme Court is discretionary—so we won't know if the case will be taken up for six months to a year. In the meantime, California businesses will need to continue to raise their virtual paddles to obtain the allowances they need to comply. •

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