

Cooley

“As clear as mud”?

Major Issues under Reinsurance Contracts

Where Are We Now?

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- 40+ years of litigation and court decisions
- A challenging landscape in terms of risk exposure
 - Long tail
 - Cat losses
 - Underwriting agency/pool issues

Historical Overview

- From Product Liability to Financial Loss
- **1940s/1950s** - "**Coca Cola**" claims; Texas cattle feed losses
- **1958** - "**Cancerphobia**" recognised as a viable cause of action (Ferrara v Galluchio; NY High Court)
- **1970** - Pincoffs v St Paul Fire & Marine: the contamination of numerous bags of bird seed with insecticide was one "occurrence".
- **1970s -Thalidomide**: the Distillers Case : High Court of Australia: congenital defects attributable to "one source or original cause", the distribution of the drug.

- **1973 - Borel v. Fibreboard:** (US Court of App's, Sth Circuit)
 - strict liability in asbestos disease cases;
 - producers subject to joint and several liability;
 - claimant exposure to asbestos/asbestos containing product and an asbestos related disease
- **1980 - ICNA v Forty-Eight Insulations:** (US Court of App's, 6th Circuit)
 - exposure theory applied;
 - insurer duty to defend manufacturers of asbestos products;
 - proration of insurer liability during exposure period.

- **1980** - Emergence of "**Superfund**" in the USA under CERCLA 1980 (liability for environmental clean-up costs)
- **1980's**- Collapse of **US Savings & Loans Institutions**
- **1981 - Keene v INA: "triple trigger"**: (US Court of Appeals, DC)
 - 1) asbestos products inhalation exposure,
 - 2) exposure in residence and
 - 3) manifestation

1)-3) each trigger coverage
- **1984 - Owens Illinois v Aetna**: the manufacture and sale of asbestos products held to be one "occurrence"

- **1985 - Asbestos Claims Facility** ("Wellington Agreement") - generic share formulae for apportioning asbestos producer liability.
- **1990 - Invasion of Kuwait** (leading to London litigation on "occurrence"/"event")
- **1992 - Diamond Shamrock v Aetna Casualty**: the delivery of Agent Orange to the US Government was one "occurrence"
- **1980s/90s - Misselling of "investment business in the UK"**
 - Pensions misselling
 - Misselling of mortgage endowment policies

- **1987-1992 - Massive losses at Lloyd's**, including APH losses, LMX spiral losses and collapse of "old Lloyd's"
- **1990s - Lloyd's Litigation** and development of English law on "occurrence", "event" and "originating cause".
- **1996 - Equitas** set up to handle and reinsure 1992 and prior year "old Lloyd's" liabilities
- **2000s - "backdating" of stock option grants; film finance exposures.**
- **2001 - 9/11: how many loss events?**
- **2007 - The "sub prime crisis"**

- **2005-2011 - Misselling by banks in the UK of payment protection insurance (PPI) policies:**
 - Millions of complaints since 2005
 - Each complaint/claim to be investigated (High Court ruling: 20 April 2011)
- **2007 onwards - Global Financial Crisis**
 - Collapse of Bear Stearns, Lehman Brothers et al
 - Misselling of high-risk derivative mortgage products (SEC v Goldman Sachs)
 - FSA investigation into Goldman Sachs
 - Shareholder derivative suits against Goldman Sachs

- **Pyramid investment schemes ("Ponzi schemes")**
 - Madoff (and the failure of over 300 other Ponzi schemes)
- **Municipal bonds/auction rate securities**
- **LIBOR scandal**

Summary

- Some clarity brought to major contractual/legal issues
- Areas of doubt and uncertainty remain
- Unanswered questions/unresolved issues

Where are we now?

A. The Duty of Utmost Good Faith

1. Disclosure of material facts

CLEAR:

- the duty of utmost good faith requires the reinsured to disclose to the reinsurer every material circumstance which the reinsured knows, or should, in the ordinary course of business, know.

CLEAR:

- Every circumstance which would influence the judgment of a prudent reinsurer in fixing the premium, or determining whether or not to underwrite the risk, is “material”.

2. Inducement

CLEAR:

- any material non-disclosure must have induced the actual underwriter to participate: “subjective inducement”.
- Where there has not been a fair presentation of the risk, one needs to determine what would have constituted a fair presentation and what would have been said to make the presentation more attractive. (*AXA v ARIG* [2017]; Court of Appeal).

3. Renewals and Variations

CLEAR:

- the duty of disclosure revives prior to renewal and when variations are under consideration.

4. Material Misrepresentation

CLEAR:

- every material representation made by the reinsured, or its agent, to the reinsurer during the placement of the reinsurance, must be true.
- A representation as to a matter of fact is true if “substantially correct”.
- A representation of expectation or belief is true if made in “good faith”.

UNCLEAR

- Being put on enquiry: when is the line crossed between a fair presentation of the risk and putting the reinsurer on enquiry (if he wishes to know more)?
- What features of “market practice” in the London (or any other relevant market) are matters of common knowledge, not requiring disclosure.

B. Scope of the Contract

1. Express Terms

- Period clauses

CLEAR:

- Period clauses are fundamental terms, to be applied strictly

- Risks attaching

CLEAR:

- “Risks attaching” are insurances incepting during the applicable period of a reinsurance contract

- “Risks” are equated with insurance policies
- “Attachment” is equated with the inception of insurance cover
- A lineslip, binding authority or other form of “facility” is not a “risk attaching”
- There is a recognised distinction between contracts of reinsurance and contracts for reinsurance.

- **Exclusions**

CLEAR:

- Must be worded in clear and unambiguous terms. Any material ambiguity will constrict the application of the exclusion, to the detriment of the (re)insurer.

UNCLEAR

- Reinsuring clauses (in certain cases)

“all business underwritten in the Marine department”

“all business allocated to the Marine account”

- “Fundamental” terms

Possibly include the definition of the reinsured risk, excess points and limits.

Other terms?

No comprehensive list of what should be regarded as “fundamental”.

2. Implied Terms

- To be distinguished from express terms and incorporated terms

CLEAR:

- Four recognised bases for implied terms:
 - Necessary implication
 - Business efficacy
 - Trade custom or usage
 - Previous course of dealings

CLEAR:

- In non-proportional reinsurance, there is no implied duty to act prudently, with reasonable care and in accordance with ordinary market practice.
- Implied professional duties are placed on the reinsured under facultative obligatory reinsurance: to conduct business prudently, to keep full and proper records, to investigate risks properly before acceptance, to investigate claims properly.

- No implied right of inspection where full contract wording exists and omits inspection clause.
- Implied right of inspection under facultative obligatory reinsurance, evidenced only by a slip.
- Under a “follow the settlements” clause, the reinsured is under an implied obligation to act honestly and in a proper and businesslike manner when handling and settling claims.
- No implied term enabling a reinsured to recover from a reinsurer its costs and expenses incurred in the investigation and handling of claims under insurance policies.

- In a facultative reinsurance, there is an implied warranty that the original policy cannot be altered without the reinsurer's consent.

UNCLEAR:

- Which practices of the London, US or international reinsurance markets constitute trade customs or usages justifying the existence of implied terms.
- The extent to which reinsurance contracts in general, or by type, or method, are subject to implied professional duties placed on the reinsured.

3. Incorporation of Underlying Terms and Conditions

- Relevant principally in the Facultative context
- *“All terms and conditions as original”* – general words of incorporation
“Subject to same terms and conditions as the original policy”

CLEAR:

- General words of incorporation are insufficient to incorporate arbitration clauses, governing law clauses, jurisdiction clauses, or other secondary provisions.
- Also insufficient to incorporate a “follow the leader” clause (*“Following Market leaders in all respects, including rate and claims...”*).

- **Headline tests for what can be incorporated:**

Is the original policy provision:

- Germane to the reinsurance?
- Subject to permissible manipulation, sensible in the context of the reinsurance?
- Consistent with the express terms of the reinsurance?
- Appropriate for inclusion in the reinsurance?

UNCLEAR:

- How such tests really work in practice, given their rather nebulous nature.

C. Operation of the Contract

1. Aggregation mechanisms under XL contracts

CLEAR:

- Settled outline definitions of “occurrence”, “event”, “originating cause”
 - **“Occurrence”**: *"Whether or not something which produces a plurality of loss or damage can properly be described as an occurrence therefore depends on the positions or viewpoint of the observer and involves the question of degree of unity in relation to cause, locality, time and if initiated by human action, the circumstances and purpose of the persons responsible" (Dawson's Field Arbitration) (Scott v Copenhagen Re [2003] Court of Appeal)*

- Note the “Four Unities”: cause, locality, time and purpose.
- “**Event**”: must happen at a particular time, at a particular place, in a particular way
- “**Originating cause**”: can be a state of affairs, or an omission. Entails the widest possible search for a “unifying factor” in the history of the losses subject to possible aggregation.

UNCLEAR

- The application of these definitions in the latent liability context
- In particular, with reference to exposure to asbestos related diseases and gradual environmental pollution
- How are claims arising from these to be aggregated?
- What is the relevant “occurrence”, “event” or “originating cause”?

2. Follow settlements and loss settlements clauses

CLEAR:

- The outline operation of the principal forms of such clauses.

“Follow the settlements”

Effect summarised by Robert Goff LJ in *Insurance Company of Africa v Scor (UK) Reinsurance* (“Scor”) (1985), as follows:

“...the effect of a clause binding reinsurers to follow settlements of the insurers, is that the reinsurers agree to indemnify insurers in the event that they settle a claim by their assured, ie when they dispose, or bind themselves to dispose, of a claim, whether by reason of admission or compromise, provided that the claim so recognised by them falls within the risks covered by the policy of reinsurance as a matter of law, and provided also that in settling the claim the insurers have acted honestly and have taken all proper and businesslike steps in making the settlements.”

Further elaboration: Gavin Kealey QC in *Assicurazioni Generali SpA v CGU International Insurance Plc* (2003):

Reinsurers bound by “all settlements... (a) provided that the claims so recognised.... fall within the risks covered by the contract of reinsurance as a matter of law: by which is meant in this context... provided that the claims were settled on a basis which, if and assuming it to be valid, falls within the risks covered by Generali’s outward contract of reinsurance as a matter of law and (b) provided that Generali acted honestly and took all proper and businesslike steps in making such settlements.”

Yet further elaboration: Gavin Kealey QC:

“When one is examining the claim so recognised by the insurers when they settle it by admission or compromise one is examining the real basis on which the claim has been settled...one is looking to identify the factual and legal ingredients of the claim embodied and thus recognised in the settlement...”

“Loss settlements”

“All loss settlements by the Reassured including compromise settlements....shall be binding upon the Reinsurers providing such settlements are within the terms and conditions of the original policies and/or contracts and within the terms and conditions of the Reinsurance”

(See Hill and Charman v The Mercantile and General (1996) – excess of loss reinsurance).

Reinsurers free to assess whether – as a matter of law (the legal implications of the facts) – any given settlement falls within the contractually defined scope of both the insurance and reinsurance – BUT without re-opening factual matters on which claim based. In other words, this clause is concerned with the extent to which “loss settlements” are binding on reinsurers, not with an open enquiry into any factual matters relating to the loss itself which gave rise to the original claim.

UNCLEAR:

- Precisely where the line is to be drawn between identification of the factual and legal ingredients of the claim settled and open enquiry into factual matters relating to the loss producing that claim.

UNCLEAR

- The precise legal effect of every variant of the follow settlements or loss settlements clause eg JELC Excess Loss Clauses (2013)

“It is a condition precedent to liability under this Contract that settlement by a reassured shall be in accordance with the terms, conditions and exclusions of the original policies or contracts.”

- The meaning of “follow the fortunes”
- The exact composition of proper and businesslike steps

- **Proper and Businesslike Steps**

CLEAR:

- The reinsured is under an obligation to:
 - Take reasonable steps to ascertain relevant facts relating to a claim and to investigate available defences
 - Take appropriate legal advice
 - Appoint competent loss adjusters (and in a business like way)
 - Ensure, through supervision, that loss adjusters adjust claims in a businesslike way
 - Settle claims in a businesslike way (by reference to their merits, not extraneous considerations)

UNCLEAR:

- Is it businesslike to accept liabilities where there is no, or insufficient, evidence of original policy coverage?
- At what point is it businesslike to end further investigation into a claim?

3. Ex gratia payments

CLEAR:

- These are payments falling outside (re)insurance cover as a matter of objective analysis.
- Not covered unless expressly so stated.
- “Follow the settlements” wording alone will not permit recovery of ex gratia payments.

4. Without Prejudice settlements

CLEAR:

- These are payments made without admission of/without prejudice to liability.
- Not covered unless expressly so stated.

5. Commutations

- Usually entail a payment for outstanding issues and IBNR.
- Sometimes lacking precise apportionment across applicable years of coverage.

CLEAR:

- Outstanding losses are not ascertained losses
- Losses incurred but not reported (IBNR) are not ascertained
- Commutations fall outside reinsurance coverage, absent agreement to embrace them.

- A “loss settlements” clause rendering loss settlements, including compromise settlements, binding on reinsurers, is insufficient to render reinsurers liable for commutation settlements.
- A “follow the settlements” clause will not facilitate recovery of commutations.
- Commutations should, of course, be capable of being “unpacked” so as to identify elements for recovery under reinsurance contracts.

6. Allocation and Apportionment

1) When reinsurance cover exists over a period of years:

CLEAR

- When the relevant cover is placed on a time basis, the duration of cover is fundamental and must be given effect to. It is for that period of risk exposure that the premium payable is assessed.
- This is so, whether the cover is defined by reference to when physical loss or damage occurred, or by reference to when a liability was incurred, or a claim made.

- Accordingly, a reinsured does not have freedom to allocate settled losses on a purely self-serving basis.

(Municipal Mutual v Sea Insurance [1996]; Court of Appeal.

Also Wasa v Lexington [2010]; House of Lords)

2) Where there is a series of losses within a single year of reinsurance cover:

CLEAR:

- Claims must be allocated (to primary and excess layers) in the order in which losses are established and quantified (which includes the ascertainment of liability by agreement, judgment or award).
- A reinsured is not entitled to present its losses in whatever order it chooses in order to maximise reinsurance recoveries.

- Manipulation only permissible, therefore, to the extent some claims are able to be disputed while others are settled. This would delay the establishment and quantification of liability in relation to certain claims. The order of settlements made would therefore be affected.

(Teal Assurance Co Ltd v W R Berkley [2013]; Supreme Court)

3) Where the date of loss is beyond determination (typically Mesothelioma).

CLEAR

- The need to prove causation in accordance with established principles is removed, because of the inability of medical science to prove which precise period of exposure actually led to Mesothelioma.
- Judicial creativity has resulted in the “**material increase of risk**” test for the purpose of establishing employer liability towards Mesothelioma victims. (*Fairchild v Glenhaven* [2002]; House of Lords)

- “Fairchild principle” extended to lung cancer (*Heneghan v Manchester Dry Docks* [2016]; Court of Appeal)
- Each employer jointly and severally liable for 100% of the loss (Compensation Act 2006).
- Contribution between responsible employers available

- In **employers' liability insurance**, insurers are liable on a “loss occurring” basis by reference to asbestos exposure because bodily injury occurs at that time. (*Durham v BAI (Run Off) Ltd* [2012]; Supreme Court)
- Not the manifestation of lung damage: which is too late to make insurance cover available for claims relating to former employees.
- Every exposure produces a liability, so each insurer faces 100% liability in every year it was on risk of the employer's liability.
- Not “time on risk” apportionment of liability between insurers.

- **Contribution between insurers** is available to enable any insurer facing 100% liability to recoup from other insurers, adopting a “time on risk” basis. (*Zurich Insurance PLC v International Energy Group* [2015]; Supreme Court).
- Responsible insurer recoupment from Employer also permissible for years where there was in fact no insurance cover.
- The risk of insolvency of other insurers lies with the responsible insurer (against whom the claim is made).

UNCLEAR:

- Whether the insurer claimed against must bear the risk of insolvency of the Employer in relation to the recoupment claim for payments made by that insurer in respect of uninsured years.
- The extent to which reinsurance contracts placed on a time basis will follow these innovative principles in the context of Mesothelioma (and similar) claims.
- Or will the approach adopted in relation to identifiable loss dates apply?

7. Claims co-operation clauses (in facultative reinsurance)

- Typically requiring the reinsured to give prompt notice of claims, to co-operate with reinsurers in the investigation and assessment of any loss and to seek the approval of reinsurers prior to settlement or admission of liability.

CLEAR:

- When designated a condition precedent, a failure to comply with a claims co-operation clause operates as a total bar to recover under the contract

UNCLEAR:

- What “co-operation” fully entails in practice
- What does “co-operation” in the investigation and assessment of any loss really mean in practice?
- The extent of a reinsurer’s entitlement to refuse consent to a particular step in the handling, or settlement, of a claim.

Professional Biography

James Crabtree advises on insurance and reinsurance claims, coverage disputes and contractual issues, often with an international dimension. His practice focuses on complex disputes concerning a diverse range of risk sectors, including marine and energy, political and trade credit risks, D&O, E&O, banks and other financial institutions, property damage and business interruption (including mining risks) and pharmaceutical risks (including product liability and product recall). James also advises on disputes in respect of global insurance programmes and captive insurance.

Over the years, his work has entailed dealing with major losses such as Piper Alpha, Phillips Petroleum, the 2011 Japanese tsunami and the 2011 New Zealand earthquake, as well as with insurance claims arising from the collapse of Barings Bank, the collapse of WorldCom, various film finance transactions and the Argentine economic crisis of 2002.

He also advises on the terms and conditions of insurance and reinsurance contracts and on the management of insurance/reinsurance portfolios in runoff. He has advised on and handled disputes in relation to all methods and types of reinsurance.

According to Chambers Directory 2017, James Crabtree "receives high praise from clients, who consider him an "extremely savvy and well-versed lawyer, familiar with the intricacies of the field." Other similarly impressed sources describe him as a "very deliberating lawyer" who is calm under pressure and "provides legal solutions which are both effective and commercial."

James Crabtree has received Finance Monthly's Fintech Award for 2017 UK Insurance & Reinsurance Lawyer of the Year.

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