

# **IS THERE A GAP BETWEEN WHAT THE INDUSTRY OFFERS AND WHAT THE WORLD WANTS**

## **HOW THE COURTS AND LAW ARE HANDLING ISSUES OF STRICT WORDING**

*Rob Merkin  
Southampton University; Barlow Lyde & Gilbert*

### **Initiatives**

Moves towards the regulation and control of strict wording have come from a variety of sources, statutory, voluntary and hybrid.

- London Market Principles 2001, a market initiative
- Contract Certainty, a regulatory initiative requiring market action
- Statutory control of policy terms, an EU initiative
- Statutory regulation of the conduct of insurers
- Judicial control of obligations
- Judicial approach to construction

Note also the Law Commission's ongoing investigation into insurance law, which is likely to lead to statutory codes for consumer and commercial insurance, including reinsurance.

### **London Market Principles**

These were the result of deliberations between Lloyd's and the International Underwriting Association (previously ILU and LIRMA) from July 1999 onwards, resulting from concerns as to the documentation (or lack of it) used in the placement process. The essential principles are:

- (1) a standardised structure for the slip to ensure clarity and completeness at the outset, removing the need for terms subsequently to be agreed with the leading underwriter on behalf of the following market;

- (2) a single leading underwriter to manage the underwriting and administrative process and to have significantly greater powers to act on behalf of the following market;
- (3) greater use of pre-defined policy wordings;
- (4) greater use of leading underwriter clauses which empower the leader to agree changes on behalf of the London market;
- (5) the leading underwriter to be responsible for ensuring that sufficient policy details are maintained on behalf of the market to simplify subsequent claims processing;
- (6) insuring that documentation is in a single document produced by the broker nominated by the leading underwriter;
- (7) de-linking of procedures so that each individual stage can be speeded up, eg the separation of the provision of closing information and the settlement of the premium;
- (8) a central slip/policy registration service for the whole market;
- (9) the leading underwriter is to be responsible for risk registration;
- (10) the introduction of a market-wide risk coding system;
- (11) the progressive introduction of the production of all documents in electronic format;
- (12) the removal of expired wordings.

For the operation of LMP in practice, see the International Hulls Clauses 2003 which attempt to implement these principles in a specific context: the wording is clearer, the duties of the parties are set out clearly and the consequences of breach are specified. Success: less than 5% of shipowners want to use them.

## **Contract certainty**

Under a regulatory initiative launched by the Financial Services Authority in December 2004, the FSA challenged the London to find a solution to the problem of inadequate documentation which has long bedevilled the creation and confirmation of insurance and reinsurance contracts, referred to by the FSA as “deal now detail later”. The reversal of the traditional haphazard approach is regarded by the FSA as essential to the creation of an efficient, orderly and fair market which operates in a transparent fashion and which is competitive. The deadline for a market solution was given as December 2006. Taking up this challenge, two working groups were established by the market, the Subscription Market Reform Group (which is concerned with the “slip” market) and the Non-Subscription Market Reform Group (which is concerned with all other insurance transactions. The Subscription Market Reform Group issued a Code of Practice dated 10 October 2005. The Non-Subscription Reform Group issued a Code of Practice on 1 September 2005 which applies to all contracts made and renewed on or after 1 October 2005. Under the Codes, the market has undertaken to ensure that the terms of agreements are

clear from the outset, to eliminate over-subscription and to provide contract wording within 30 days of inception. Significant progress has been reported on both fronts: the non-subscription market for commercial policies was estimated at over 80% compliance in June 2006.

## **Statutory control of policy terms**

Under the Unfair Terms in Consumer Contracts Regulations 1999, SI 1999/2083, implementing Council Directive 93/113/E, the terms of consumer contracts, including insurance contracts, are subjected to a fairness requirement. Under the Regulations, as applied to insurance, a term is deemed to be unfair under regulations 3 and 4 if:

- (a) it has not been individually negotiated, i.e. it has been drafted in advance and the assured has not been able to influence its substance, the burden of proof being on the insurer if the assured alleges lack of individual negotiation; and
- (b) it is contrary to the (undefined) requirement of good faith; and
- (c) it creates a significant imbalance in the parties' rights and obligations.

In every case the unfairness of a contractual term is to be assessed by “taking into account the nature of the goods or services for which the contract was concluded and by referring, at the time of the conclusion of the contract, to all the circumstances attending the conclusion of the contract and to all the other terms of the contract or of another contract on which it is dependent”.

Schedule 2 to the Regulations sets out an illustrative list of terms which may fall foul of the fairness requirement. Transposing that list to the insurance context, terms which might be thought at least potentially to be at risk might include:

- (a) a term conferring on the insurer the right to terminate the policy at any time;
- (b) a term under which the assured forfeits the premium in the event that the policy is avoided;
- (c) any term which is not reasonably accessible to the assured prior to the making of the contract;

- (d) any term which provides that the insurer's agent is the agent of the assured for the purposes of the completion of the proposal;
- (e) any term which restricts the assured's access to judicial remedy, e.g. a term which shortens the limitation period by requiring judicial proceedings to be brought within a fixed period.

Regulation 3(2), imposes a fundamental restriction on the operation of the Regulations. It excludes from judicial scrutiny "core provisions", i.e., any term which either defines the subject matter of the contract or concerns the adequacy of the price or remuneration as against the services supplied, provided that the term is expressed in "plain, intelligible language". This provision effectively means that the assured cannot challenge the fairness of an insuring clause or of an exceptions clause by asserting that the premium charged is too high when set against the actual cover provided, unless the wording is couched in complexities. Similarly, the amount of a deductible would seem to fall within the core provision. It is uncertain whether the core provision excludes from scrutiny wording which is on its face plain and intelligible, but which bears a hidden meaning, e.g. "riot", "theft" or "event". In addition, regulation 7 requires that any term in a consumer contract which has not been individually negotiated has to be given the interpretation most favourable to the assured, thereby, as noted above, codifying the *contra proferentem* principle.

In applying the 1999 Regulations the starting point is to determine whether the term under consideration is one that defines the subject matter or the adequacy of the price or remuneration. It is apparent that the premium itself, the insuring clause and the exceptions clause will fall within this category, and that in these circumstances the question is whether the term is one that has been expressed in plain, intelligible language, failing which it is to be construed against the insurers and its fairness falls to be considered. In *Bankers Insurance Co Ltd v South* [2004] Lloyd's Rep IR 1 a travel policy taken out by a friend of the assured, and under which the assured was one of a number of insured persons, excluded cover for the assured's liability incurred "involving your ownership or possession of any . . . motorised waterborne craft". The assured injured a third party in jet-ski collision. One was whether the exclusion encompassed what had occurred. Buckley J. held that the exclusion was a "core" provision so that it was not subject to the fairness test, and instead the only question was whether it had been expressed in plain, intelligible language. Buckley J.'s view was that a

jet-ski was in ordinary parlance a motorised waterborne craft and that there was no ambiguity involved. However, even if that were wrong, the term was not unfair as the assured had been given the opportunity to read the policy and the policy was a cheap one.

If the term is not a “core” term, but is ancillary to the main obligations of the insurer under the policy, then it is to be judged by the fairness test. It would seem from the limited authority under the Regulations that a clause is automatically void only to the extent that it is incapable of operating fairly, and thus remains valid but merely unenforceable where giving effect to the clause would act unfairly in the circumstances. In *South* the further issue was the binding effect of conditions precedent to the insurers’ liability in the form of an obligation to notify as soon as reasonably possible all incidents that may result in a claim and an obligation to forward all relevant communications to the insurer. The assured was in serious breach of each of these provisions. Buckley J. held that conditions precedent were by their nature unfair as they precluded recovery irrespective of the seriousness of the assured’s breach. The learned judge went on to hold that the Regulations did not strike down the clauses in their entirety, but instead prevented the insurers from treating them as conditions precedent to liability unless the breach was one that caused serious prejudice to the insurers. In so deciding Buckley J. rejected the alternative suggestion that the condition precedent element of a clause was automatically wiped out leaving the clause as a bare condition.

## **Statutory regulation of the conduct of insurers**

One of the characterising features of the regulation of insurance law in England has been the absence of “material control” of policy terms, the emphasis being on protection against insolvency. The Financial Services and Markets Act 2000 changed all that. The Financial Services Authority established under the Act has been busy with contract certainty (see above). More significantly, the Act has given a statutory basis to the Insurance Ombudsman Bureau (in existence since 1981, administering Codes of Practice in force since 1977 and renewed in 1986), now known as the Financial Ombudsman Service. The General Insurance Code of Practice was replaced by the Insurance Conduct of Business Rules, set out in the FSA Handbook. The FOS must, under section 228(2) make decisions which are “fair and reasonable in all the circumstances of the case” rather than in accordance

with strict law. The FOS has jurisdiction over complaints brought by “eligible complainant,” defined as a private individual or a business with a group annual turnover of less than £1 million. ICOB 7.6 provides as follows

### **Rejecting or refusing claims**

An insurer must not:

- (1) unreasonably reject a claim made by a customer;
- (2) except where there is evidence of fraud, refuse to meet a claim made by a retail customer on the grounds:
  - (a) of non-disclosure of a fact material to the risk that the retail customer who took out the policy could not reasonably be expected to have disclosed;
  - (b) of misrepresentation of a fact material to the risk, unless the misrepresentation is negligent;
  - (c) in the case of a general insurance contract, of breach of warranty or condition, unless the circumstances of the claim are connected with the breach; or
  - (d) in the case of a non-investment insurance contract which is a pure protection contract, of breach of warranty, unless the circumstances of the claim are connected with the breach and unless:
    - (i) under a life of another contract, the warranty relates to a statement of fact concerning the life to be assured and that statement would have constituted grounds for rejection of a claim by the insurer under ... (a) or (b) if it had been made by the life to be assured under an own life contract; or
    - (ii) the warranty is material to the risk and was drawn to the attention of the retail customer who took out the policy before the conclusion of the contract.

### **Judicial control of obligations**

Obligations imposed upon assureds are often in the form of conditions precedents and warranties. Breach of the former automatically precludes recovery irrespective of prejudice; breach of the latter automatically terminates the risk. To date the courts have been able to do very little about warranties, but as regards conditions they have developed three mechanisms

- refusing to construe conditions as conditions precedent even if they say so (lots of cases on this)
- restricting the remedies available to insurers in the event of a breach of a condition which is not a condition precedent (see *Friends Provident v Sirius* [2006] Lloyd’s Rep

IR 45 – denial of doctrine of partial repudiation, so that insurers have a remedy only if the entire policy is repudiated by breach)

- holding that insurers are under some form of continuing duty to the assured (good faith/implicit term) to act rationally in deciding how discretions are to be exercised (*Gan v Tai Ping* [2001] Lloyd's Rep IR 667 (whether to give permission for defence costs to be incurred), *Eagle Star v Cresswell* [2004] Lloyd's Rep IR 437 (whether to take over settlement negotiations), *Drake Insurance v Provident Insurance* [2004] Lloyd's Rep IR 277 (whether to avoid), *Diab v Regent Insurance* [2006] UKPC 29 (whether to extend time for compliance with fixed-term claims condition))

## Judicial approach to construction

The relevant principles of construction were codified by Lord Hoffmann in *Investors Compensation Scheme v West Bromwich Building Society* [1998] 1 All ER 98:

- “(1) Interpretation is the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract.
- (2) The background was famously referred to by Lord Wilberforce as the “matrix of fact”, but this phrase is, if anything, an understated description of what the background may include. Subject to the requirement that it should have been reasonably available to the parties and to the exception to be mentioned next, it includes absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man.
- (3) The law excludes from the admissible background the previous negotiations of the parties and their declarations of subjective intent. They are admissible only in an action for rectification. The law makes this distinction for reasons of practical policy and, in this respect only, legal interpretation differs from the way we would interpret utterances in ordinary life ...
- (4) The meaning which a document (or any other utterance) would convey to a reasonable man is not the same thing as the meaning of its words. The meaning of words is a matter of dictionaries and grammars; the meaning of the document is what the parties using those words against the relevant background would reasonably have been understood to mean. The background may not merely enable the reasonable man to choose between the possible meanings of words which are ambiguous but even (as occasionally happens in ordinary life) to conclude that the parties must, for whatever reason, have used the wrong words or syntax (see *Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd* [1997] 2 WLR 945).

- (5) The 'rule' that words should be given their 'natural and ordinary meaning' reflects the commonsense proposition that we do not easily accept that people have made linguistic mistakes, particularly in formal documents. On the other hand, if one would nevertheless conclude from the background that something must have gone wrong with the language, the law does not require judges to attribute to the parties an intention which they plainly could not have had. Lord Diplock made this point more vigorously when he said in *Antaios Cia Naviera SA v Salen Rederierna AB, The Antaios* [1985] AC 191 at 201:

‘ . . . if detailed semantic and syntactical analysis of words in a commercial contract is going to lead to a conclusion that flouts business common sense, it must be made to yield to business common sense.’”

It was subsequently suggested by Lord Steyn in *Sirius International Insurance Co (Publ) v FAI General Insurance Ltd* [2005] 1 Lloyd’s Rep 461 that the courts should adopt a “tendency against literalism” and a commercial approach to interpretation in “one-off” contracts, although more recently it has been confirmed that Lord Hoffmann’s test does not permit the court to manipulate the words used by the parties in order to reach a construction which the court regards as appropriate (Longmore L.J. in *Royal & Sun Alliance v Dornoch* [2005] Lloyd’s Rep IR 544).

Of the many recent cases on interpretation, see:

**Margate Theatre Royal Trust Ltd v White and Axa Insurance UK plc [2005] EWHC 2171 (TCC)** The assured’s public liability policy covered liability incurred in the course of his business, described as “Ground Works and Pipe Moleing.” The assured carried out some plumbing work for the claimant Theatre in 1997, but a claim was made against him for negligence when a universal joint failed and the theatre was flooded in 2003. The policy was losses occurring and so in temporal terms applied to the claim. The issue was whether plumbing work fell within the description of the assured’s business. HHJ Peter Coulson QC held that there was coverage. The plumbing work was of a similar type to that carried out by a pipe moler, and the policy was to be treated as covering all work necessary for and incidental to ground work and pipe moleing. Although this particular activity was not covered by the description in the policy, that was not surprising because the description was naturally brief and merely indicated the core business covered. Further, the policy covered activities carried out “in connection with” the assured’s business, and this could be so described (given the wide meaning that “in connection with” had in other contexts, eg, the scope of arbitration clauses). Finally, the insurers were to be taken to know that plumbing work was ancillary to that of the assured. The fact that at the time the assured had not been carrying out his main activity of ground work and pipe moleing was irrelevant, as the policy could not have a different scope depending upon the circumstances in which the plumbing work was done. The court regarded as irrelevant the fact that the insurers had a different and higher premium rate for plumbers: that was subjective evidence which was inadmissible under the accepted rules of construction.

**Canelhas Comercio Importacao e Exportacao Ltd v Wooldridge [2004] Lloyd’s Rep IR 915**

CC was a wholesale jeweller carrying on business in Sao Paulo, and was insured at Lloyd's under an all risks policy in the sum of US\$3,000,000. The insurance contained a "Holdup or Robbery Limit" clause under which cover was removed in respect of loss of or damage to property by robbery when the premises were open for business or when the assured or any of their employees were present. The proprietor of CC was kidnapped along with his wife, son and mother, and was told – with threats against his family - to go to the premises and remove all of the emeralds. He did so, and claimed against his insurers. The Court of Appeal held that the loss had occurred at CC's premises so that the limitation on the amount recoverable was inapplicable. A reasonable commercial person viewing this clause would assume it to mean that the hold-up had to take place at the assured's premises, and not that an employee would be kidnapped and forced to remove goods from the premises. Further, the duress under which the proprietor had been placed had no connection with the premises.

### **Tektrol Ltd v International Insurance Co of Hanover Ltd [2005] EWCA Civ 845**

The claimant manufactured energy saving control devices for industrial motors, the main product being a "PowerMiser" which relied on computer code. The code was stored on two computers and a paper printout at the claimant's premises, on a laptop, and on a dataserer operated by CS. In December 2001, the claimant received an e-mail containing a virus. When opened it damaged computer files on the laptop and the dataserer. The claimant wrongly believed that the damage had been repaired. In January 2002, the claimant's premises were burgled, and the two development computers and the paper print-out of the code were stolen. It then became apparent that the only two remaining copies had been damaged. The claimant had an all risks and business interruption policy. The policy excluded loss "directly or indirectly" resulting from, under cl 7(b)(i), "erasure loss distortion or corruption of information on computer systems or other records programmes or software caused deliberately by rioters strikers locked-out workers persons taking part in labour disturbances or civil commotion or malicious persons". Clause 7(b)(ii) excluded loss caused by "other erasure loss distortion or corruption of information on computer systems or other records programmes or software unless resulting from a Defined Peril in so far as it is not otherwise excluded". It was common ground that the virus had been created by a malicious person for the purposes of cl 7(b)(i) and that theft was not a Defined Peril for the purposes of cl 7(b)(ii).

The Court of Appeal, reversing Langley J, held that the assured could recover. It was common ground that if either the virus or the burglary was an excluded peril the assured would be unable to recover, on the principle that if there are two causes of loss then the exclusion takes priority (as had been held by Langley J). The assured thus had to prove that both causes of loss were insured, and the Court of Appeal held that it had done so.

As to cl 7(b)(i), Langley J ruled that the loss was excluded because the virus had been deliberately created by malicious persons: the fact that the virus had not been specifically targeted at the claimant did not mean that the loss was not deliberate. The Court of Appeal unanimously overturned this ruling. The phrase "malicious persons" took its meaning from the context of the phrase, and while that phrase taken alone could apply to random and untargeted malicious acts, the wording in context (rioters, strikers, etc) indicated a targeted act against the assured. Random hacking was not, therefore, excluded.

As to cl 7(b)(ii), Langley J held that the word "loss" was not limited to electronic loss so that the claim was excluded under that head as well. The Court of Appeal by a 2:1 majority (Carnwath LJ dissenting) held that the word "loss" was also to be construed in its context, and was concerned with loss of software rather than loss of the equipment on which the software was stored.

Carnwath LJ expressed the view that he was glad that he was in the minority: “Although it is described as an “all risks” policy, one has to search long and hard, through a bewildering and apparently comprehensive list of exclusions, to discover the extent to which any risks are in fact covered.”

**GE Frankona Reinsurance Ltd v CMM Trust No 1400, The Newfoundland Explorer [2006] EWHC 429 (Adm)**

A yacht was insured by GE on the terms of the Institute Hulls Clauses Port Risks 1987, which provided “Warranted fully crewed at all times”. The vessel had one full time Captain and two part-time crew members. The vessel was destroyed by fire when an onboard generator overheated. The Captain had been on board shortly before the fire, but had gone home (about 30 minutes away by car). The insurers asserted that the warranty was a suspensory provision (and not a full warranty) under which they were not on risk at any time when there was not a crew member on board: accordingly they were not liable for the loss. The assured argued that the clause did not require a crew member to be on board at all times but simply provided for the assured to employ a crew at all times. Gross J, finding for the insurers, adopted an intermediate approach: the phrase “fully crewed at all times” required the assured to keep a member of crew on board at all times subject to: (i) emergencies rendering his departure necessary or (ii) necessary temporary departures for the purpose of performing his crewing duties or other related activities. The judge relied upon the ordinary and natural meaning of the words used and the commercial purpose of the warranty.

# **AVOIDING THE UNBRIDGED GAP BETWEEN INSURANCE AND REINSURANCE:**

## **IDENTIFYING AND UNDERSTANDING THE KEY AREAS OF DISPUTE BETWEEN INSURERS AND REINSURERS**

*Rob Merkin*

*Southampton University; Barlow Lyde & Gilbert*

### **Reasons for disputes**

Analysis of reinsurance disputes over the past decade shows that they tend to fall into the following classes:

- disclosure/representation issues
- the binding effect of settlements reached by the reinsured
- drafting – the absence of wordings
- drafting – the use of inappropriate wordings
- drafting – the use of untested wording

Drafting accounts for the majority of disputes. Treaties may be long or short, but their terms relate exclusively to reinsurance and for the most part are concerned with premium calculation and payment of losses. Facultative contracts have traditionally been in slip policy form and have used the “full reinsurance clause”, some variation on “as original and follow the settlements”. It remains to be seen whether this wording will be abandoned in the current climate of “Contract Certainty”. Facultative contracts frequently support a fronting mechanism which allows overseas risks to be brought to the London market, and the intention is that the reinsurance cover and the direct cover should match. Careless drafting does not always permit this to happen.

The courts have striven to assist the parties to reinsurance agreements and to make commercial sense of often haphazard arrangements. A reinsurance framed as a direct life policy and thus which contravened the insurable interest rules in the Life Assurance Act 1774 was rescued by judicial sleight of hand (*Feasey v Sun Life Assurance Co of Canada* [2003] Lloyd’s Rep IR 637), the market practice

of arranging reinsurance in advance of insurance has been upheld by smoke and mirrors (the root case being *General Accident Fire and Life Assurance Corporation v Tanter, The Zephyr* [1985] 2 Lloyd's Rep 529), and the House of Lords has ruled that the words "and shall actually have paid" are sufficiently ambiguous to justify a finding that the reinsured was entitled to an indemnity even though it had not made payment (*Charter Re v Fagan* [1996] 3 All ER 46). There are limits to judicial intervention, as *Bonner v Cox* [2006] Lloyd's Rep IR 385 (below) illustrates.

### **Disclosure and representation**

It is necessary to disclose/avoid misrepresenting to reinsurers:

- facts material to the direct risk, and
- facts material to the reinsurance

As to the former, in recent cases material facts have been held to be: that the director of an insured bank under a fidelity policy was under investigation for fraud (*Brotherton v Aseguradora Colseguros SA (No 3)* [2003] Lloyd's Rep IR 774) that a footballer insured under an accident policy had a previous injury (*Prifti v Musini Sociedad Anonima de Seguros y Reaseguros* [2004] Lloyd's Rep IR 528.) and that the insured subject matter was not clocks but valuable Rolex watches (*WISE Underwriting Agency Ltd v Grupo Nacional Provincial SA* [2004] Lloyd's Rep IR 764). There is a proven problem here in that information given by the assured to the insurers is simply passed on to reinsurers without further thought. *WISE* is a good example, the original slip in Spanish having been (mis)translated into English and submitted to reinsurers as the proposal for reinsurance.

As to the latter, reinsureds are required to disclose: their own risk assessment (*Feasey v Sun Life of Canada* [2002] Lloyd's Rep IR 835) and claims handling processes (*Assicurazioni Generali SpA v Arab Insurance Group* [2002] Lloyd's Rep IR 131 – unsubstantiated allegation that reinsured's method of reserving was eccentric); claims experience (*Aiken v Stewart Wrightson Members Agency Ltd* [1995] 2 Lloyd's Rep 618, *Groupama Insurance Co Ltd v Overseas Partners Re Ltd* 2003, unreported); the fact that the direct policy is written on a valued rather than indemnity basis (*Toomey v*

*Banco Vitalicio de Espana SA de Seguros y Reaseguros* [2005] Lloyd's Rep IR 423); the fact that the direct risk is on a facultative-obligatory basis rather than on a purely obligatory basis (*Aneco Reinsurance Underwriting Ltd v. Johnson & Higgins* [2002] Lloyd's Rep IR 91); and the fact that the assured had paid a higher premium than appeared to be the case (*Markel International Insurance Company Ltd and another v La Republica Compania Argentina de Seguros Generales SA* [2005] Lloyd's Rep IR 90).

## Settlements

It is now settled (see *Insurance Company of Africa v. Scor (U.K.) Reinsurance Ltd* [1985] 1 Lloyd's Rep. 312) that the term "follow the settlements" means that the reinsured can prove its loss either by being sued to judgment or award, or by entering into a bona fide and businesslike settlement (the latter possibility does not exist in the absence of these words – *Commercial Union Assurance Co v. NRG Victory Reinsurance Ltd* [1998] Lloyd's Rep IR 421, *King v Brandywine Reinsurance Co (UK) Ltd* [2005] Lloyd's Rep IR 509) although the reinsurers are free to rely upon their own policy terms to defend any claim. That principle brings the two limbs of the "full reinsurance clause" into conflict, because the reinsured's policy terms are those of the reinsurers. In *Assicurazioni Generali Spa v CGU International Insurance plc* [2004] Lloyd's Rep IR 457 it was decided (in effect) that the reinsurers cannot rely on their own wording if that would conflict with the interpretation adopted by the reinsured in entering into a bona fide and businesslike settlement on the same wording.

Once it became apparent that follow settlement clauses achieved their purpose, reinsurers sought to cut back their liabilities by the use of 'claims co-operation' or 'claims control' clauses, the former typically requiring the reinsured to notify the reinsures of the occurrence of circumstances likely to give rise to a claim, to investigate the circumstances of the loss in order to satisfy themselves that an insured peril has occurred and that sums are due under the policy, and to provide information to reinsurers. The latter transfers control of all claims to the reinsurers. In *Scor* it was decided that claims clauses prevail over follow settlements clauses so that if the clause is framed as a condition precedent any breach is fatal. It is uncertain whether breach of a claims condition not so framed automatically deprives the reinsured of the right to rely on a follow the settlements clause. Any discretion conferred

upon reinsurers under a condition precedent in a manner which precludes recovery by the reinsured, eg, in refusing to agree to a settlement or in refusing to take over negotiations with the assured under a claims control clause, cannot be challenged on the ground that the reinsurers have acted unreasonably, as this would require the court to second-guess the reinsurers' commercial judgment, although the reinsurers owe a duty – based either on implied term or good faith – to act rationally in the sense that the considerations taken into account by them must relate to the claim and not to any extraneous matter (*Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd (Nos 2 and 3)* [2001] Lloyd's Rep IR 667).

### **The absence of wordings**

The assumption of the market that the courts will fill in any gaps left open by the parties was given a severe jolt by the Court of Appeal in *Bonner v Cox* [2006] Lloyd's Rep IR 385. Of the many issues, the most important was the assertion that the reinsured had "written against" the reinsurance by accepting loss-making business. The Court of Appeal overturned the suggestion first made in *Phoenix v Halvanon* [1985] 2 Lloyd's Rep 599 that there were implied terms in facultative-obligatory proportional (and, presumably also an obligatory) treaty, as regards: (a) keeping proper records and accounts of risks accepted, premiums received and claims made or notified; (b) investigating all claims and confirm that there is liability before liability is accepted; (c) acting prudently in the acceptance of risks; (d) keeping full and accurate accounts showing sums owing and owed; (e) ensuring that all amounts owing are collected promptly, and that all amounts payable are paid promptly; and (f) making all documents reasonably available to reinsurers. The Court of Appeal held that (c) did not apply to a non-proportional treaty, and by implication that none of the suggested implied terms were relevant to any form of treaty.

### **The use of inappropriate wordings**

Inappropriate terms find their way into reinsurance contracts either by incorporation, by bad drafting or by the lifting of irrelevant precedents from the precedent bank.

## *Incorporation*

As far as incorporation is concerned, the use of the “full reinsurance clause” goes back well over a century, to wording such as “warranted all terms and conditions as original”, these days abbreviated to “as original”. It is generally assumed (although there are dissenting judicial voices) that these words operate to incorporate the terms of the direct policy into the reinsurance (see *Vesta v Butcher* [1989] AC 852). Incorporation has proved to be fraught with difficulties, in particular where the direct policy and the reinsurance are governed by different applicable laws so that incorporation of the same wording does not necessarily create back to back cover. The courts have strived to create back to back cover despite the parties’ best endeavours. *Vesta* is itself an example, where the direct policy was governed by Finnish law and the reinsurance by English law, the Finnish system taking a generous view of breach of warranty but the English system taking a strict view: the House of Lords held that the reinsurers were obliged to pay the reinsured despite a breach of warranty by the assured, as that was the result reached by Finnish law which was to be incorporated into the English law reinsurance. Subsequently, in *Groupama Navigation v Catatumbo* [2000] 2 Lloyd’s Rep 350, the Court of Appeal extended the *Vesta* principle to the situation in which the reinsurance contained its own warranty, but this was held to be overridden by the warranty incorporated from the direct policy so as to produce back to back cover.

All of this aside, there are two major problems with incorporation. The first is, what can be incorporated? After much litigation it has now become clear that: (1) provisions which relate directly to the risk can be incorporated unless they are not normally found in direct policies, or they been added to the direct policy after the inception of the reinsurance, or they purport to allow the direct leading underwriter to vary the risk (the situation in *American International Marine Agency of New York Inc v Dandridge* [2005] EWHC 829 (Comm)); (2) notice clauses and similar obligations will be incorporated only to the extent that they make sense in the reinsurance context; and (3) dispute resolution clauses – arbitration (*Tryg Hansa v Equitas* [1998] 2 Lloyd’s Rep 439), jurisdiction (*Prifti v Musini Sociedad Anonima de Seguros y Reaseguros* [2004] Lloyd’s Rep IR 528), choice of law (*Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd* [1999] Lloyd’s Rep IR 472) – cannot be incorporated without express reference.

The second problem, which arises on the assumption that there has been incorporation, is whether the incorporated term is incorporated exactly as it stands (so that it consists of a statement of the position under the direct policy) or whether it is “manipulated” (so that it is adapted to have effect as between reinsured and reinsurers). In *HIH Casualty and General Insurance v New Hampshire Insurance* [2001] Lloyd’s Rep IR 596 the Court of Appeal held that a waiver of disclosure provision contained in the direct policy had been incorporated into the reinsurance in its unmanipulated form, so that it did not amount to a waiver of disclosure by the reinsurers as against the reinsured but rather operated to impose liability on the reinsurers where the reinsured had lost the right to avoid as against the direct assured.

The problem of incorporation is not confined to the full reinsurance clause. In *Axa Re v Ace Global Markets Ltd* [2006] EWHC 216 (Comm) an arbitration clause and an exclusive jurisdiction/choice of law clauses were incorporated from other documents, side by side: the court gave priority to the former.

### *Bad drafting*

Some recent examples of bad drafting include:

- (a) a claims control clause which provided “(b) The Underwriters hereon shall control the negotiations and settlements of any claims under this Policy. In this event the Underwriters hereon will not be liable to pay any claim not controlled as set out above – in *Eagle Star Insurance Co Ltd v Cresswell* [2004] Lloyd’s Rep IR 437 this wording was held to mean that reinsurers had the right to refuse to control, thereby denying the reinsured recovery;
- (b) a clause in a three year policy which provided that “The reinsurer reserves the right to increase the Annual Premium at any Anniversary Date during the Term on a pro rata basis, if prior to the Termination Date, there is a material change in the normal underwriting guidelines, classes of business, volume of business or proportion of business, as described in the submission and/or any extraordinary claims developments” – the Court of Appeal in *Charman v New Cap Reinsurance Corporation Ltd* [2004]

Lloyd's Rep IR 373 felt just about able to rescue this clause from being void for uncertainty and held that it entitled reinsurers to increase the premium on an objective pro rata basis

### *Irrelevant precedents*

Some recent examples of the use of irrelevant precedents include:

- (a) *Royal and Sun Alliance Insurance plc v Dornoch Ltd* [2005] Lloyd's Rep IR 544, where a reinsurance of a D&O policy provided that "the Reassured shall upon knowledge of any loss or losses which may give rise to claim under this policy, advise the Underwriters thereof by cable within 72 hours" – it was unclear whether the loss was that of the claimants against the assured, that of the assured or that of the reinsured, although in the result the case turned on the fact that until the reinsured obtained knowledge of any judgment against the assured there was no obligation to notify, a construction which in effect rendered the clause meaningless
- (b) *CNA International Reinsurance Co Ltd v Companhia de Seguros Tranquilidade SA* [1999] Lloyd's Rep IR 289, where a direct policy written in Portugal to cover loss of profits in the event of the cancellation of concerts incorporated Lloyd's liability insurance wording and was then reinsured "as original". The court rewrote the policy.

### **The use of untested wordings**

Various clauses have been in common use in the London market for many years, and there have been decisions clarifying their meaning. There seems to be a tendency for those drafting reinsurance policies to try something new, without any indication as to whether the purpose is to codify or to change the earlier interpretation. Recent examples include:

- (a) the use of "follow the fortunes" rather than "follow the settlements" – in *CGU International Insurance plc v Astrazeneca Insurance Co Ltd* [2006] Lloyd's Rep IR 409

everyone agreed that the two things were different, but that was the extent of the agreement;

- (b) the addition of the words “without” question in a follow the settlements clause – this phrase was held to add nothing to the ordinary meaning, in *Assicurazioni Generali Spa v CGU International Insurance plc* [2004] Lloyd’s Rep IR 457
- (c) the exclusion of “ex gratia and without prejudice” settlements from a follow the settlements obligation – in *Faraday Capital Ltd v Copenhagen Reinsurance Co Ltd* [2006] EWHC 1474 (Comm) the phrase was held to exclude a bona fide and businesslike final settlement which happened to say that it was “without prejudice”