AVOIDING THE UNBRIDGED GAP BETWEEN INSURANCE AND REINSURANCE:

IDENTIFYING AND UNDERSTANDING THE KEY AREAS OF DISUTE BETWEEN INSURERS AND REINSURERS

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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 Reasseguros [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”