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UNIVERSITY OF SOUTHAMPTON

FACULTY OF LAW, ARTS & SOCIAL SCIENCES

School of Law

**FACULTATIVE REINSURANCE AND THE FULL
REINSURANCE CLAUSE**

By

Ozlem Gurses

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ABSTRACT

FACULTY OF LAW, ARTS & SOCIAL SCIENCES

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FACULTATIVE REINSURANCE AND THE FULL REINSURANCE CLAUSE

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The Full Reinsurance clause by which a reinsurer agrees to be bound by the same terms and conditions as the original policy and commits to follow the reinsured's settlements is widely used in London Market facultative reinsurance contracts. In most disputes the outcome depends upon resolving the fundamental question of whether reinsurance is either a further insurance on the subject matter insured or is a reinsurance of the liability of the reinsured under the direct policy. The interpretation of the clause had not been settled until the recent House of Lords decision on *Wasa International Insurance Co Ltd v Lexington Insurance Co* [2009] UKHL 40 where their Lordships adopted the view that reinsurance is not a liability insurance but a further insurance on the subject matter insured by the reinsured.

Settlement clauses are also widely used in the United States, albeit with wording slightly different from that of the full reinsurance clause but there is broad consensus in the US courts that the words 'follow the fortunes' and 'follow the settlements' are interchangeable. There are both similarities and differences between the two common law systems: in England the full reinsurance clause has to be express, whereas in the US there is a debate as to whether it may be implied; in England the nature of reinsurance remains unresolved, in the US the liability approach has been adopted; post-settlement allocations have created huge problems in the US but have scarcely been discussed in England; the US cases have not proceeded on the basis of incorporation whereas in England the scope of incorporation has been much discussed. These differences arise mainly from the understanding of reinsurance in the two systems, and the present thesis aims to explain these conflicting understandings by describing the relationship between reinsurers and reinsureds in the light of 'as original', 'follow the form' and 'settlement' clauses.

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DECLARATION OF AUTHORSHIP

I, Ozlem Gurses, declare that the thesis entitled

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and the work presented in the thesis is my own and has been generated by me as the result of my own original research. I confirm that:

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INTRODUCTION

1. Background

In the London Market facultative reinsurance contracts have traditionally been made simply by appending to the original policy a cover page containing the full reinsurance clause, the typical formulation of which is “Being a reinsurance of...subject to the same terms and conditions as original and follow the settlements of the Company”¹. The cover page is described as a slip policy:² no other policy is issued and the full reinsurance clause is the only indication as to the scope of coverage under the reinsurance. The first part of the clause defines the terms upon which the reinsurance has been made and the second part obliges the reinsurer to indemnify the reinsured for settlements which have been reached with the direct policyholder.

In English law the function of the words “as original” is unresolved: one view holds that they incorporate the original policy terms into the reinsurance; whereas the alternative view is that they simply confirm that in facultative reinsurance, in the absence of any express contrary provision, the two contracts offer identical cover. Clarification is fundamental to resolving problems such as whether incorporation is necessary to achieve common coverage, and how to interpret the two contracts when the applicable laws are different. Recently, these matters came before the English courts in *Wasa v Lexington*.

¹ The clause may also be abbreviated to “as original”. This kind of wording is still permissible under the Contract Certainty Code of Practice so long as the original policy terms are clearly identified by attaching or uniquely describing or referencing (Appendix 2: Sample checklist content).
http://www.iaa.co.uk/AM/Template.cfm?Section=Contract_Certainty1&CONTENTID=2791&TEMPLATE=/CM/ContentDisplay.cfm (last visited on 27 July 2009).

² As an administrative practice in the London Market the slip may refer to a choice of forms, J1 or NMA 1779. The J1 form contains the clause “Being a reinsurance of and warranted same gross rate, terms and conditions as and to follow the settlements of the [reassured].” The NMA 1779 form does not have a follow settlements clause. However it contains an obligation: “...to pay or to make good to the Reinsured all such Loss as aforesaid as may happen to the subject matter of this Reinsurance, or any part thereof during the continuance of this Policy.” In *Wasa International Insurance Co Ltd v Lexington Insurance Co.* [2009] UKHL 40, the slip provided for a choice of forms at the option of the broker and also conditions were stated as to be “The Full Reinsurance Clause”. One commentator has strongly emphasised that one or other of these forms must have been chosen, as such choice must be made at the time when the reinsurance premium is closed to the market. The commentator is of the opinion that NMA 1779 was the chosen form. Weir, “A Matter of Forms and Substance”, [2009] LMCLQ 210, 217, 235. However, the House of Lords found this discussion irrelevant and accepted it as a common ground that the wording of the clause was “Being a reinsurance of and warranted same gross rate, terms and conditions as and to follow the settlements of the Company and that said Company retains during the currency of this Policy at least on the identical subject matter and risk and in identically the same proportion on each separate part thereof, but in the event of the retained line being less than as above, Underwriters’ lines to be proportionately reduced.”

The House of Lords did not clarify the functions of the as original clause and classified the case as “exceptional”. Therefore the case should be read with caution.

2. Aims and Objectives

The thesis focuses upon the construction of the “Full Reinsurance Clause”, which in one form or another is almost always found in London Market facultative reinsurance contracts and indeed in other markets. This thesis tries to clarify the nature of reinsurance and the implications of adopting the two different approaches to its definition.

This thesis also aims to explain the function of settlement clauses in English law and in various jurisdictions in the US. Settlement clauses are sometimes used along with claims provisions, and the thesis also considers to what extent claims provisions and settlement clauses can be reconciled.

Finally, the thesis analyses issues which are fully resolved in the US but await determination in England. For instance while the nature of reinsurance is uncontroversial in the US, the issue went to the highest court in the UK. Again implying a follow the settlements clause into all reinsurance contracts or applying the clause to reinsureds’ post-settlement allocations have been heavily discussed in the US; in England the former has been rejected and the latter not considered. These similarities and dissimilarities are explained in detail and a summary will be provided in conclusion.

3. Structure and Methodology

This thesis is in three parts:

First, the thesis looks at the application of the phrase “as original”. Its function to a large extent depends on the correct interpretation of the nature of facultative reinsurance contracts, where the reinsurer assumes all or some part of the risk accepted by the reinsured. If that reinsurance takes effect as a further insurance on the insured subject matter, the words “as original” have the function of incorporating the terms of the original policy into the reinsurance. On the other hand, if reinsurance operates in a fashion similar to liability insurance, the function of the phrase “as original” is more limited, reinforcing

the presumption of back-to-back cover which applies to proportional reinsurance. At this point the thesis discusses that presumption, pointing out that in facultative contracts (and especially where the insurance is part of a fronting operation), unless the contrary is provided, reinsurance and insurance contracts are presumed to provide matching cover. Since the presumption allows the court to interpret the two contracts in the same way, unless the parties expressly agree otherwise, incorporation of the original policy terms is not necessary to a finding of identical cover.

The thesis suggests that the latter approach is preferable and that reinsurance is a form of liability cover. However, the House of Lords in *WASA v Lexington* adopted the conventional view and stated that reinsurance is a further insurance on the subject matter originally insured. Accordingly the words effect the incorporation of the original policy terms. Therefore, it has been necessary to analyse the requirements for incorporation, in particular the classes of term that can be incorporated and the implications of incorporation for unusual terms, inconsistent terms and particular terms which may operate differently at the direct and reinsurance levels, such as waiver of defence and variation clauses.

Secondly, the thesis examines the operation of the latter part of the “Full Reinsurance Clause”, the “Follow the Settlements” wording.

This part of the thesis starts by tracing the genesis of the clause as, “to pay as may be paid thereon”. The issue here is the interpretation of the clause by the courts in the late nineteenth and the early twentieth centuries. It has been found that the “to pay as may be paid thereon” clause was not construed by the courts in accordance with the likely intention of its draftsman and was held to add nothing to the common law rule that the reinsured must prove its loss. That wording was replaced by the words “to pay as may be paid thereon and follow the settlements”, subsequently altered to “follow the settlements”.

It seems that almost all reinsurance disputes are referred to arbitration in the twentieth century, and it was as late as 1985, in *Insurance Co. of Africa v SCOR (UK) Reinsurance Co. Ltd.*³, that the “follow the settlements” clause first came to be analysed. In that case the Court of Appeal held that when a reinsurer agrees to follow the settlements of the

³ [1985] 1 Lloyd’s Rep. 312.

reinsured he agrees to trust both the reinsured's honesty and professionalism, so that the reinsured is entitled to be indemnified by the reinsurer for liability incurred under a settlement unless the reinsurer can prove that the settlement was not made in a bona fide and businesslike manner or that the loss falls outside the terms of the reinsurance cover.

Since 1985 this case has been applied and approved in a series of subsequent decisions. However the wording of the "follow the settlements" clause is not standard and the market sometimes uses variations on it.

By way of example, the full reinsurance clause may be drafted: "...the reinsurer will follow the settlements whether the reinsured is liable or not liable"; "the reinsurer agrees to be bound by the reinsured's settlement providing such settlements are within the terms and conditions of the original policies and within the terms and conditions of this reinsurance"; or "...the reinsurer agrees to follow without question the settlement of the reinsured except ex-gratia and/or without prejudice settlements." It has therefore been necessary to examine the various forms of the follow the settlements clause.

A closely allied point is the relationship of the follow the settlements clause with claims provisions. The problem arises where a reinsurance contract contains the two provisions side by side. The controversy here is that the follow the settlements clause expresses the reinsurer's trust towards the reinsured whereas the claims provision restricts the reinsured's right to settle the claim without the active involvement – to a greater or lesser extent – of the reinsurer. The reconciliation of these two clauses is also explained in this thesis.

Thirdly, the thesis focuses on settlement clauses in the US reinsurance market. There is no standard full reinsurance clause in the US but the formulation of such clauses is different to that of the London Market. In this part of the thesis, the difference between the wording of the clauses is considered. The interpretation of the "follow the form" and "follow the fortunes/follow the settlement" clauses is discussed. The research demonstrated that there are major differences between the understanding of reinsurance in the two systems, which become apparent when the interpretation of the clauses is explained. The research was not limited to any particular State jurisdiction, as there are relatively few cases on the relevant clause and the US Courts usually refer to cases from all US jurisdictions.

4. Outcomes

As a result of the research the following points will be made clear in England and in the US:

- What is reinsurance
- The function of the full reinsurance clause
- Whether “as original” / “follow the form” clauses operate to incorporate the original policy terms into reinsurance and, if so, the scope of incorporation
- The presumption of back-to-back cover (England) and providing concurrent cover (US)
- Differences between “follow the settlements” and “follow the fortunes” clauses
- Nature and function of claims provisions, remedies for breach of such clauses and their relationship with the settlement clauses.

PART A : REINSURANCE UPON THE SAME TERMS AS ORIGINAL

CHAPTER 1 THE NATURE OF FACULTATIVE REINSURANCE

Facultative reinsurance is a contract “which consists of the reinsurance of a single risk reinsured on a proportional basis, in that the reinsured retains an agreed proportion of the risk and passes some or all of the remainder to the reinsurers”⁴. The key issue is whether the “as original” wording carries the terms of the original insurance contract into the reinsurance agreement, a matter not judicially settled yet⁵ but whose determination depends upon the nature of facultative reinsurance. Some of the cases have adopted the view that reinsurers insure the reinsured’s liability for his undertaking to indemnify the assured under the original insurance contract. For that reason the purpose is that of ensuring that the liability of the reinsurers matches that of the reinsured⁶. This view gives a limited function to the words “as original”, unless it is clear from other policy terms that incorporation is intended. On the other hand, in a number of cases, and until recently these represented the accepted view, the suggestion has been that reinsurance is a further insurance upon the same subject matter as the original contract of insurance. This view means that the phrase “as original” incorporates the terms of the original insurance into the reinsurance contract. Both views are examined in detail below, and the author’s own conclusions are then presented.

1.1 The View That Reinsurance is a Further Insurance

In the early development of reinsurance, a contract of reinsurance was defined as “a new assurance effected by a new policy on the same risk which was before insured in order to indemnify the underwriters from their previous subscriptions”⁷. This analysis has been adopted by subsequent authorities: In *British Dominions General Insurance Company v.*

⁴ Merkin, *Colinvaux’s Law of Insurance*, para 17-01; see also O’Neill and Woloniecki, *The Law of Insurance in England and Bermuda*, para 1-13.

⁵ Lord Mustill in *Charter Reinsurance Co. v Fagan* [1996] 2 Lloyd’s Rep 113, 117; *Enterprise Oil Ltd v Strand Insurance Co Ltd* [2006] 1 Lloyd’s Rep 500.

⁶ *Butler and Merkin’s Reinsurance Law*, para B-0116; Lord Griffiths in *Forsikringsaktieselskapet Vesta v Butcher* [1989] 1 Lloyd’s Rep 331, 336; *Pine Top Insurance Co. Ltd. v Unione Italiana Anglo Saxon Reinsurance Co. Ltd.* [1987] 1 Lloyd’s Rep 476, *WASA International Insurance Co Ltd v Lexington Insurance Co* [2008] 1 CLC 340.

⁷ Mansfield CJ in *Delver v Barnes* (1807) 1 Taunt 48, 51.

*Duder*⁸ Buckley LJ expressed his view that a reinsurance contract insured the subject matter of the original insurance⁹. Later cases have expressly denied that a contract of reinsurance is one of liability insurance¹⁰. In *CNA International Reinsurance Co Ltd & Ors v. Companhia de Seguros Tranquilidade SA*, where the reinsured affected a policy against the cancellation of a series of concerts by Plácido Domingo, Clarke J held that the subject matter of the reinsurance was not the liability of the original insurer to the assured but rather the non-appearance of the performer¹¹.

1.2 The View That Reinsurance is a Liability Insurance

Despite these views, in other cases it has been asserted that the reinsurance is a contract by the reinsurer to indemnify the reinsured against liability under the original insurance policy¹².

In *D.R. Insurance Co. v. Seguros America Banamex* Adrian Hamilton QC rejected the idea that reinsurance is a further insurance on the subject matter insured¹³. Further, in *Home Insurance Company of New York v. Victoria-Montreal Fire Insurance Company*, in explaining the inapplicability of a direct insurance notice term to the reinsurance contract, Lord Macnaghten defined reinsurance as a contract which “against the liability or a portion of the liability undertaken by the original insurer or the insurer covering the original insurer’s direct liability”¹⁴.

⁸ [1915] 2 KB 394, 400. See also *Mackenzie v Whitworth* (1874-75) LR 10 Ex 142; *Uzielli & Co v The Boston Marine Insurance* (1884) 15 QBD 11; *Nelson v Empress Assurance Corporation* [1905] 2 KB 281, 285; *Forsikringsaktieselskabet National (of Copenhagen) v Attorney-General* [1925] AC 639, 642 (here the reinsurance contract was a treaty rather than facultative); *CGU International Insurance v AstraZeneca Insurance Co* [2006] Lloyd’s Rep IR 409; Simon J in *Wasa International Insurance Co Ltd v Lexington Insurance Co* [2007] Lloyd’s Rep IR 604.

⁹ However, in the same case, Bankes LJ stated that as between the reinsurers and the reinsured the value of the subject-matter of the insurance was agreed, and the former had contracted to reinsure a certain proportion of the latter’s liability in respect of that agreed value [1915] 2 KB 394, 411.

¹⁰ *Toomey v Eagle Star Insurance*, per Hobhouse LJ, [1994] 1 Lloyd’s Rep 516, 522.

¹¹ [1999] CLC 140. See also *Aegis Electrical and Gas International Services Co Ltd v Continental Casualty Co.* [2008] Lloyd’s Rep IR 17.

¹² Lord Templeman in *Vesta v Butcher* [1989] 1 Lloyd’s Rep 331, 334; *Western Assurance Company of Toronto v Poole* [1903] 1 KB 376, 386; *South British Fire and Marine Insurance Co v Da Costa* [1906] 1 KB 456; *English Insurance Co v National Benefit Assurance Co.* [1929] AC 114; Merkin, “Incorporation of Terms Into Reinsurance Agreements”, *The Modern Law of Marine Insurance* Vol 2, 64; Carter, *Reinsurance*, 115; Louw, *Golding: The Law and Practice of Reinsurance*, 13.

¹³ [1993] 1 Lloyd’s Rep 120, 129. See also *Fireman’s Fund Insurance Co v Western Australian Insurance Co.* (1927) 28 Ll LR 243, 251.

¹⁴ [1907] AC 59, 63. See also Waller J in *Municipal Mutual Insurance Ltd v Sea Insurance Co Ltd* [1996] CLC 1515 (a point not appealed to the Court of Appeal).

The leading authority is now *Wasa v Lexington*¹⁵. Sedley LJ here expressed the view that the purpose of reinsurance was to cover the primary insurer against an agreed proportion of the loss it may incur under its own policy¹⁶. *Wasa v Lexington* is significant in clarifying the nature of facultative reinsurance and the interpretation of the contracts where the terms are written in a more or less identical fashion¹⁷. The case is discussed in detail later in this thesis.

1.3 Controversies in the “Further Insurance” View

In analysing the two approaches, the “further insurance” concept appears fraught with difficulties.

1.3.1 Privity of Contract

First, if reinsurance is a further insurance of the subject matter of the original insurance, it is arguable that a contractual relationship is established between the reinsurer and the assured. The test to determine whether a contract is one of reinsurance was expressed by Lord Atkin in *English Insurance v. National Benefit*¹⁸ as “whether or not the re-insurers or the alleged re-insurers have assumed a contractual liability to the original assured, for such an original contractual liability is not an incident of re-insurance, and if such an original liability had been assumed then there would have been a contract of insurance...”. It is clear that in reinsurance contracts there is no privity between the assured and the reinsurer¹⁹. Consequently, the assured cannot make a direct claim against the reinsurer and a reinsurance contract does not contain any undertaking in favour of the assured²⁰. This

¹⁵ [2008] 1 CLC 340.

¹⁶ [2008] 1 CLC 340, 362.

¹⁷ Merkin, “The construction of facultative contracts”, *Ins LM*, June 2008, 1-4.

¹⁸ [1929] AC 114, 124.

¹⁹ Marine Insurance Act 1906, s.9(2) provides: “unless the policy otherwise provides, the original assured has no right or interest in respect of such reinsurance”. See also *Hobhouse J in Phoenix General Insurance Co. of Greece S.A. v Halvanon Insurance Co. Ltd.* [1985] 2 Lloyd’s Rep 599, 614; *Re Law Guarantee Trust and Accident Society* [1914] 2 Ch 617; *Versicherungs und Transport A/G. Daugava v Henderson* (1934) 49 Ll LR 252, however, controversially Scrutton LJ also declared that the reinsured had insurable interest in the subject matter originally insured.

²⁰ It should be noted that a reinsurance contract may, by virtue of a cut-through clause, provide that the assured can make a direct claim against the reinsurer in the event of the liquidation of the reinsured. However as the clause is provided by the reinsurance contract where the assured has no privity with, the objection as to the enforcement of the clause may appear. The passing of the Contracts (Rights of Third Parties) Act 1999 has removed this objection by allowing a person who is not a party to a contract to enforce its terms if it expressly provides that he may or it identifies him as a beneficiary of the contract (s.1(1)). A cut-through clause could thus be interpreted as an express clause providing that the third party can make a claim against the reinsurer. See Butler and Merkin, para D-0151-D-0177; *Colinvaux’s Law of Insurance*, para 17-02; Merkin, R, *A Guide to Reinsurance Law*, 259-261. There may, however, be problems under the general *pari passu* principle applicable to unsecured creditors with enforcing a cut-through clause where the

contradiction was recognised in *Forsikringsaktieselskabet National v. Attorney-General*²¹ where Viscount Cave LC pointed out that “... the reinsurer does not become directly liable to the original householder who insures against fire, but it does undertake with the ceding office to take over a part of its liability under those policies”. However if reinsurance is a further insurance, it is arguably the assured who could make a claim against the reinsurer for any loss resulting from the occurrence of the insured peril²². It is also noteworthy that Viscount Cave LC’s comment that “the reinsurer undertakes with the ceding office to take over a part of its liability under those policies” clearly indicates that reinsurance is in essence a liability insurance.

It is also worth noting that reinsurers are entitled to seek a declaration that they are not liable according to the reinsurance policy terms for the payment that the reinsured has made but they cannot seek declaratory relief as to the reinsured’s liability to the assured under the original policy. This was decided in *Meadows Insurance Co Ltd v Insurance Corporation of Ireland Ltd*²³ where the reinsurer sought declarations to the effect that the reinsured was entitled to avoid, or alternatively was not liable, under the original policy. Following *dicta* of Lord Diplock in *Gouriet v Union of Post Office Workers*²⁴ the Court of Appeal emphasised that the reinsurer was a third party to the relationship between the assured and the reinsured and consequently had no right to seek a declaration with respect to the rights of those parties.

1.3.2 Insurable Interest

The view that reinsurance is a further insurance also assumes that the reinsured has an insurable interest in the subject matter insured by virtue of the original contract of insurance²⁵. The Marine Insurance Act 1906 s.9(1) can be interpreted as supporting this interpretation as it provides that “The insurer under a contract of marine insurance has an insurable interest in his risk, and may re-insure in respect of it”. Referring to s.9(1),

reinsured is insolvent: in fact, cut-through clauses are by their terms only triggered by an insolvency, so their validity remains doubtful.

²¹ [1925] AC 639, 642.

²² Golding, 7.

²³ [1989] 2 Lloyd’s Rep 298.

²⁴ [1978] AC 435, 501.

²⁵ *British Dominions v Duder* [1915] 2 KB 394, 400. See also Mathew LJ in *Nelson v Empress* [1905] 2 KB 281, 285; *Forsikringsaktieselskabet National v Attorney-General*; *CGU v Astrazeneca*; in *Feasey v Sun Life Assurance Co of Canada* [2002] 2 All ER (Comm) 492 Langley J was also prepared to adopt this view.

Hobhouse LJ in *Toomey v Eagle Star Insurance Co.*²⁶ expressed the view that the reinsured's insurable interest has to be identified by reference to the original policy and the reinsurer should be entitled to the benefit of any protection that the reinsured has obtained under the original contract of insurance.

The word "risk" within the meaning of s.9(1) of the MIA 1906 needs to be clarified. The risk may be interpreted either as the insurer's financial risk of indemnifying the assured or the loss of the subject matter of the original insurance. In *Mackenzie v Whitworth* Amphlett B stated that "... the fact of the policy being a re-insurance is only a limitation on the liability of the second insurer, and does not make his risk cease to be a risk on goods"²⁷. However such early decisions were handed down at a time when reinsurance policies were effected as second insurance against the loss of the subject matter insured by another policy²⁸. As a result, what must be specified was held to be the subject matter of insurance and not an interest in it²⁹. Therefore it was immaterial for the underwriters to know that the policy was reinsurance³⁰. Secondly, by reference to Hobhouse LJ's opinion in *Toomey v Eagle Star*, it can be argued that there is no need to afford to the reinsurer the reinsured's protection under the original policy. It should be remembered that the reinsured has no actual legal interest in the property which is the subject matter of the original insurance, and therefore its interest must be confined to the nature and scope of the liability which it has undertaken under the direct insurance³¹. To make a claim against the reinsurers, the reinsured has to establish and quantify its loss, ie, its liability to the assured³². This means that if the reinsured is permitted to rely on an exclusion clause in the original policy but it fails to do so and makes payment, such payment would be classified as "ex-gratia" and accordingly outside the cover of reinsurance. Consequently, it

²⁶ [1994] 1 Lloyd's Rep 516, 522-523.

²⁷ (1874-75) LR 10 Ex 142, 151.

²⁸ The parties manipulated the word "insurer" as "reinsurer" in the standard form of original insurance policies. See Merkin "Incorporation of Terms", 61; O'Neill/Woloniecki, para 1-27. In *Dalby v India* (1854) 15 CB 365 the insurers had insured the life of the Duke of Cambridge, and had taken out their own policy which they maintained in force even after the primary insurance had been surrendered. Merkin has argued that the second policy was in some form of reinsurance but this view was not considered in *Feasey v Sun Life*.

²⁹ (1875) LR 10 Ex 142, 148; see also *Carruthers v Sheddon* (1815) 6 Taunt 14; *Crowley v Cohen* (1832) 3 B & Ad 478 where it was emphasised that the nature of the interest did not need to be properly described.

³⁰ See Merkin, "Incorporation of Terms", 61.

³¹ Golding, 8.

³² *Charman v Guardian Royal Exchange Assurance Plc.* [1992] 2 Lloyd's Rep 607, 613.

appears that the insured risk is a concern of the reinsurers only because it forms the reinsured's liability and not because it is the subject matter of the original insurance³³.

Nevertheless after *Feasey v Sun Life*, it is apparent that much depends upon the drafting of the reinsurance agreement³⁴. In *Feasey* the majority of the Court of Appeal³⁵ held that the reinsured, Steamship Mutual, had an insurable interest in the lives of employees of its member shipowners, but this decision was based on the express wording of the reinsurance. Although SM had reinsured its liability up until 1994 under ordinary contracts of reinsurance, due to changes in reserving requirements relating to liability insurance policies at Lloyd's new policy wordings were developed and the traditional liability wording was abandoned in favour of the formulation that the subject matter of insurance was personal injury or death suffered by employees of the reinsured's member shipowners and others on board their vessels. Therefore the point at issue was SM's insurable interest in the well-being of employees of its member shipowners. As this was a life policy, the court did not look for any legal or equitable interest in the subject matter insured and the majority of the Court of Appeal concluded that the Club had pecuniary interest in personal injury or death of employees and others. Such interest was held to exist at the outset as SM had legal obligations to members which could lead to SM having to pay substantial sums. Consequently the *Feasey* case supports the idea that insurers may have insurable interest in the subject matter of the original insurance but only if the wording of the policy so provides. The dispute settled before further appeal, so it remains open at the level of the House of Lords as to whether the majority view in *Feasey* is applicable to ordinary reinsurance cases.

1.3.3 Co-insurance / Double Insurance

It has been submitted that reinsurance should be distinguished from double insurance and co-insurance³⁶. Double insurance arises where the assured takes out more than one policy on the same subject matter, risk and interest³⁷. Co-insurance arises where there are two or

³³ In some early authorities the reinsured's insurable interest was regarded as loss originating from his contractual liability under the original insurance policy but they also held that reinsurance policy was on the subject matter of the original insurance: Brett MR in *Uzielli v Boston Marine Insurance Co.* (1884-85) LR 15 QBD 11, 16-17; *Bradford v Symondson* (1880-81) LR 7 QBD 456.

³⁴ *Colinvaux's Law of Insurance*, para 17-04.

³⁵ [2003] Lloyd's Rep IR 637.

³⁶ Lowry and Rawlings, *Insurance Law: Doctrines and Principles*, 390.

³⁷ *Colinvaux & Merkin's Insurance Contract Law*, para C-0630.

more subscribing insurers to the contract³⁸. If it is correct to say that reinsurance is a further insurance on the original subject matter, it becomes possible to argue that reinsurance is a form of co-insurance, because both the reinsurer and the reinsured are insuring the same risk. However, the assured has no contract with the reinsurer, so the co-insurance argument cannot stand. For the same reason, reinsurance cannot be regarded as double insurance, because the assured cannot be said to have taken out two policies on the same risk: it is simply the case that there are two policies on the same risk, but with different policyholders.

In the London Market risks which cannot be insured directly by reason of local regulatory requirements are brought to the market via fronting arrangements where the local insurer acts as a front by underwriting the risk and reinsuring most or all of it with reinsurers³⁹. If reinsurance is a further insurance, it is possible to argue that reinsurance should be classified as co-insurance where the reinsured cedes most of the risk or double insurance where it cedes the whole of the risk insured⁴⁰. Admittedly, the view that reinsurance is a further insurance assumes that the relevant interest is the reinsured's interest in the subject matter insured and this seems to be a feature which distinguishes insurance from reinsurance, but in fact the risk is the reinsured's financial loss for its undertaking against the assured. Essentially it is only the assured who possesses an insurable interest in the subject matter insured by the original contract of insurance. Another distinguishing feature is that in the context of reinsurance the insurer handles and is responsible for settling original incoming claims which it then seeks to pass on to his own reinsurer, whereas in co-insurance there is mutuality of interest between insurers⁴¹. In addition to that, lack of privity of contract distinguishes reinsurance from double insurance⁴².

³⁸ The term co-insurance is also commonly used to refer to the situation in which there are two or more assureds insured for their respective rights and interests under a single policy. See *Colinvaux & Merkin's Insurance Contract Law*, para A-600. The term is not used in that sense here.

³⁹ *Colinvaux's Law of Insurance*, para 17-01.

⁴⁰ It should be pointed out that in Switzerland fronting arrangements are made by means of co-insurance where only the leading co-insurer (licensed in Switzerland) is named in the contract with the direct assured. While the co-insurers share the risk according to their proportion, only the leading co-insurer assumes the risk in full and the direct policyholder has no claim against the other co-insurers. This relationship is regarded as reinsurance. See Merkin, *What is Reinsurance*, 77. However this is not the form that the London market applies.

⁴¹ *Roar Marine Ltd v Bimeh Iran Insurance Co* [1998] 1 Lloyd's Rep 423.

⁴² Legh-Jones, Birds, Owen, *MacGillivray on Insurance Law*, para 33-2.

1.4 The Preferable Opinion

It has to date not been proved necessary to determine conclusively whether reinsurance is a further insurance or liability insurance⁴³. However in practice the implications are of some significance. Determination of the nature of facultative reinsurance is particularly important where the terms of the reinsurance and the underlying insurance are identical and the reinsured has been held liable in circumstances in which the reinsurer believes itself not to be liable. In such a case, if facultative reinsurance is regarded as an independent insurance of the same risk as that covered by the direct insurance, it is easier to argue that the reinsurance covers only those risks which fall within the terms of the reinsurance as construed in accordance with its own applicable law⁴⁴. However, if its purpose is to cover the primary insurer's loss that may be incurred under the direct policy, then the reinsurer will be obliged to indemnify the reinsured on the ground that the reinsured's liability to the assured has been established and quantified⁴⁵. Moreover the function of the phrase "as original" varies depending upon which theory is recognised: as seen in various parts in this thesis, acceptance of the incorporation point of view may have the effect of extending the reinsurer's liability beyond that actually contracted for and in some cases could even amount to a re-writing of the contract of reinsurance by the courts⁴⁶. For these reasons it appears that it is crucial to ascertain the nature of reinsurance and this thesis puts forward the suggestion that the subject matter of reinsurance is the liability of the reinsured arising from his engagement under the original insurance contract. Beside the points raised above, additional reasons for this suggestion are as follows.

First, the earlier authorities, such as *Delver v Barnes*⁴⁷ were decided at a time when reinsurance contracts were effected by a further insurance on the same subject matter as that of the previous policy and where the parties manipulated the word used to bring that about, eg, "insured" became "re-insured". Such practice led to the understanding that

⁴³ O'Neill and Woloniecki, para 1-35. Moreover, in *Wasa v Lexington* Longmore LJ noted that in accepting either view the result would be the same. [2008] 1 CLC 340, 358.

⁴⁴ Sedley LJ, *Wasa v Lexington* [2008] 1 CLC 340, 362.

⁴⁵ Sedley LJ, *Wasa v Lexington* [2008] 1 CLC 340, 362.

⁴⁶ See below, Heading nos 2.4.2.2. and 2.4.3.

⁴⁷ (1807) 1 Taunt 48.

reinsurance was formed as a further insurance on the subject matter insured⁴⁸. Obviously this is not the current practice of the London Market⁴⁹.

Secondly, liability insurance is defined as a contract of indemnity which covers the risk of the assured incurring liability to third parties⁵⁰. Because such an agreement is a contract of indemnity, the assured cannot recover until loss is sustained and his liability for that loss has been established and quantified⁵¹. In the same way, it is clear law that in order to make a claim against the reinsurer, the reinsured has to establish and quantify his liability, either by virtue of a judgment or arbitration award against him or a settlement binding on the reinsurer⁵². In other words, the reinsured has no cause of action against the reinsurer until his liability to the assured has been ascertained⁵³. Moreover, there is a strong presumption that the risks covered by the insurance and facultative proportional reinsurance are likely to be identical as the two policies are generally to be construed back-to-back. This assumption is based on the notion that the reinsured cedes the whole or part of the risk insured to the reinsurer in return for a proportionate part of the premium. The reinsured chooses this method with the object of reducing the amount of its possible loss⁵⁴. If reinsurance is a further insurance, in fact, there may be no reason for assuming that the provisions of the two contracts are identical. Furthermore, as is the case with contracts of liability insurance, facultative reinsurance policies may also contain claims co-operation clauses whereby the reinsured undertakes not to admit liability or to settle a claim without first obtaining the reinsurer's consent. It appears that the only reason for the reinsurer to be concerned about the direct loss is that it will establish his liability. On this analysis it becomes clear that facultative reinsurance contracts cover the liability of the reinsured

⁴⁸ See also Sedley LJ's comment in *Wasa v Lexington* [2008] 1 CLC 340, 361-362.

⁴⁹ In the London Market it is often the case that the facultative reinsurance policy is subscribed before the underlying insurance has been concluded, eg *Vesta v Butcher*, and this practice also indicates that Mansfield CJ's definition in *Delver v Barnes* does not meet the modern practice of reinsurance. *MacGillivray on Insurance Law*, para 33-3.

⁵⁰ See Fletcher Moulton LJ in *British Cash and Parcel Conveyors v Lamson Store Service* [1908] 1 KB 1006, 1014; *Goddard & Smith v Frew* [1939] 4 All ER 358.

⁵¹ *West Wake Price & Co v Ching* [1956] 2 Lloyd's Rep 618; *Post Office v Norwich Union Fire Insurance Society* [1967] 2 QB 363; *Socony Mobil Oil Co Inc v West of England Ship Owners Mutual Insurance Association Ltd, The Padre Island* [1987] 2 Lloyd's Rep 529; *Bradley v Eagle Star Insurance Co.* [1989] 1 AC 597; *Cox v Bankside Members Agency Ltd* [1995] 2 Lloyd's Rep 437.

⁵² *Insurance Co of Africa v Scor (UK) Reinsurance Co Ltd* [1985] 1 Lloyd's Rep 312; *Fireman's Fund Insurance Co v Western Australian Insurance Co Ltd* (1927) 28 Ll LR 243.

⁵³ *Per Maugham LJ in Daugava v Henderson* (1934) 49 Ll LR 252, 254; *Home Insurance Company of New York v Victoria-Montreal Fire Insurance Company* [1907] AC 591.

⁵⁴ Golding, 17.

against its undertaking in the original policy⁵⁵. However, this conclusion should not be taken to mean that reinsurance is a form of general liability insurance in favour of the reinsured. That might be possible if the reinsurer was obliged to pay for the reinsured's extra-contractual liability, as where the reinsured has been held liable to pay a sum to the original assured in excess of its contractual obligation to the assured in tort or for breach of contract⁵⁶. The reinsurer is under the duty to provide indemnity to the reinsured only within the limits of the reinsured's contractual liability under the original policy⁵⁷.

In terms of calculating the limitation period in liability insurance the date of the assured's loss is the date at which his liability to the third party is established and quantified⁵⁸. If reinsurance is further insurance of the original subject matter, both the statutory – and any contractual – limitation period, should run from the same date for both the assured and the reinsured. Nevertheless, as emphasised in *Dornoch Ltd v Royal and Sun Alliance plc*.⁵⁹, notification clauses are not suitable for use in liability insurance because such clauses assume that there has been actual physical loss whereas in the liability insurance and reinsurance contexts there is no loss until liability has been established and quantified. In *Home Insurance v Victoria-Montreal* the Privy Council also stated that the reinsurer could not act until the direct loss was ascertained between parties over whom he had no control, and in proceedings in which he could not intervene. This analysis also strengthens the argument that the reinsurer insures the insurer's liability⁶⁰.

⁵⁵ See Sedley LJ in *Wasa v Lexington* [2008] 1 CLC 340, 362; Merkin, "Incorporation of Terms", 66; Carter, 4.

⁵⁶ See *Ott v. All-Star Ins. Corp.* 99 Wis 2d 635, 1981 discussed in Chapter 10 below.

⁵⁷ See Butler and Merkin, para C-0137.

⁵⁸ *Sphere Drake Insurance plc v Basler Versicherungs-Gesellschaft* [1998] Lloyd's Rep IR 35; *Halvanon Insurance Co Ltd v Companhia de Seguros do Estado de So Paulo* [1995] LRLR 303; *Baker v Black Sea and Baltic General Insurance Co Ltd* [1995] LRLR 261 (the point did not arise in the appeal). The same principle applies to excess of loss reinsurance, in that the date that the excess point is reached triggers the reinsurers' liability to the reinsured: *North Atlantic Insurance Co. Ltd. v Bishopsgate Insurance Ltd.* [1998] 1 Lloyd's Rep 459, 462. However see *Feasey v Sun Life of Canada* [2003] Lloyd's Rep IR 637 where the test was varied by express wording that the reinsurer's duty to provide indemnity arose on the happening of a given event.

⁵⁹ [2005] Lloyd's Rep IR 544.

⁶⁰ See Edelman, Burns Craig and Nawbatt, *The Law of Reinsurance*, para 4.71.

1.5 *Wasa v Lexington*

The effect of the nature of facultative reinsurance to the construction of this type of contract can clearly be seen in the recent Court of Appeal case, *WASA International Insurance Co Ltd v Lexington Insurance Co*⁶¹, which shows how the outcome can vary according to the view adopted as to the nature of facultative reinsurance. *Wasa v Lexington* illustrates many of the points made above.

Here, Lexington issued property insurance for Alcoa. The risk then was reinsured in the London Market, Wasa and AGF taking a 2.5% line. The insurance provided coverage from 1 July 1977 until 1 July 1980. The reinsurance policy contained the “Full Reinsurance Clause” and the policy period was stated to be 36 months from 1 July 1977.

In 1990s Alcoa was forced by US regulators to clean up pollution and contamination of groundwater, surface water and soil at numerous of its US manufacturing sites. The damage arose out of continuing failures, starting in 1942 and going on at least until 1986. In proceedings brought by Alcoa, Lexington was held to be liable for losses which occurred before, during and after the period 1 July 1977 to 1 July 1980. In holding the reinsured so liable the Washington Supreme Court, applying the law of Pennsylvania, placed emphasis upon the insuring clause of the original policy, which defined the insured perils as “all physical loss of, or damage to, the insured property as well as the interruption of business, except as hereinafter excluded or amended.” The Court found the wording of the clause to be very broad, and concluded that it contained no limitation as to the time of the physical loss of or damage to property. The Court also drew attention to the fact that there was no exclusion in the policy for physical loss or damage occurring before the policy’s inception.

Lexington thereafter settled the claim. However Wasa and AGF denied liability by asserting that it was never the intention that the reinsurance should respond to loss and damage occurring outside the reinsurance period and that, although a US court might take a different view, the reinsurance was governed by English law which did not permit recovery for loss or damage occurring outside the policy period. By contrast, the reinsured asserted that the two contracts were back-to-back, and therefore it was entitled to recover.

⁶¹ [2008] 1 CLC 340.

The reinsurers sought negative declaratory relief in England and at first instance Simon J decided in their favour. The learned judge accepted that the contracts were for the most part back to back, but the reinsurance was governed by English law whereas the insurance was governed by Pennsylvania law and the contracts were accordingly not back-to-back in that crucial respect. Therefore, the period clause in the reinsurance contract was to be construed in accordance with English law and was not automatically to be interpreted in the same way as that of the original policy. That was particularly the case given that it could not have been predicted in 1977 that Pennsylvania law would be applied to the direct policy and that Pennsylvania law would construe the policy as providing cover for more than three years. He declared that the reinsurance was not liability insurance but a further insurance on the subject matter originally insured. The two contracts therefore were to be analysed according to their respective applicable laws and under English law the point of focus was whether the loss fell within the reinsurance policy terms. The learned judge's conclusion was that the time period was fundamental to the cover that the reinsurers were not bound by the construction afforded to the direct policy and that the reinsurers were as a matter of English law not liable for the loss that occurred outside the three year period of cover stated in the reinsurance policy.

The reinsured appealed and the Court of Appeal unanimously reversed the first instance judgment. Longmore LJ, who gave the leading judgment, stated that even though the period was expressed in slightly different words, the two clauses were to all intents and purposes identical⁶². However Longmore LJ added that reliance on the concept of back-to-back cover was not helpful because it raised a circular argument: the reinsured argued that the parties intended that the period clauses in each policy were to be construed in the same way, whereas the reinsurers asserted that the contracts were not back-to-back in nature so that the period clauses meant different things. Longmore LJ expressed the view that the back-to-back issue disguised the real question of whether the same period of cover should receive the same interpretation in both the original insurance and the reinsurance and he concluded that in this case they did.

⁶² [2008] 1 CLC 340, 352.

The Court of Appeal found *Vesta v Butcher* and *Groupama Navigation et Transports v. Catatumbo Seguros*⁶³ - cases that will be discussed in detail below under the “presumption of back-to-back cover” heading – to be indistinguishable. In those cases warranties in the reinsurance and underlying insurance were construed in the same way even though the contracts were governed by different laws, for the reason that the presumed intention of the parties was that the two contracts were to provide identical cover⁶⁴. Longmore LJ also rejected the argument that the reinsurer could not have contemplated either an unexpected construction of the clause or a change in the law, years after the policy inception: the reinsurers, by writing their policy in the same form as the direct cover, had agreed to take the risk of such change. The reinsurers also relied on *Municipal Mutual Insurance Ltd v Sea Insurance Co Ltd*⁶⁵ as authority for the proposition that the duration clause in the reinsurance was to be construed independently of the duration clause in the direct insurance. However, the Court of Appeal distinguished *MMI* as in that case there were three different reinsurance contracts with different reinsurers (or the same reinsurers but with different percentages). The loss occurred during an eighteen-month period straddling all three years of cover, and the reinsured made the claim without allocating the loss to any particular year. It was held in *MMI* that the fact that these facts made allocation crucial, and on that basis the losses had to be allocated proportionately by reference to the duration of the liability of each of the reinsurers. However in *Wasa* there was a single reinsurance contract for the same period as the direct policy, and the duration terms were equivalent. Sedley LJ pointed out that the purpose of reinsurance was to cover the reinsured’s liability as undertaken in the original policy⁶⁶. Accordingly, the reinsurers were held to be liable for the proportion of that liability that they assumed where the reinsured’s liability was established.

In *Wasa* it is not clear whether the parties chose to use the J1 or the NMA 1779 Form, as the slip provided for an option by the broker. It stated “Form: J1 or NMA 1779 covering All Risks of Physical Loss or Damageas original” and “Conditions: Full R/I Clause No.1 amended.” The distinction is potentially significant, because NMA 1779 introduces a warranty about the insurance terms, rather than their incorporation, and also uses the

⁶³ [2000] 2 Lloyd’s Rep 350.

⁶⁴ In those cases it was also held that the original policy terms were incorporated into the reinsurance contract, although incorporation was apparently conceded in *Wasa*.

⁶⁵ [1996] CLC 1515.

⁶⁶ [2008] 1 CLC 340, 361-362.

words “...during the continuation of the policy”, giving rise to the argument that any liability would be limited to 36 months. It has been suggested by Weir that the J1 form is issued only where a full policy wording is to be provided, but in the absence of any policy the contract must have been in NMA 1779 Form.⁶⁷

The Court of Appeal accepted that NMA 1779 did not contain a follow the settlements clause. However it contained an obligation: “... to pay or to make good to the Reinsured all such Loss as aforesaid as may happen to the subject matter of this Reinsurance, or any part thereof during the continuance of this Policy.” The Court also recognised the fact that the “Full R/I Clause No. 1 as amended” referred to in the “Conditions” had not been identified, but was a standard clause used in the London market in the following terms: “Being a Reinsurance of and warranted same gross rate, terms and conditions as and to follow the settlements of the ... Company and that said Company retains during the currency of this Policy at least ... on the identical subject matter and risk and in identically the same proportion on each separate part thereof, but in the event of the retained line being less than as above, Underwriters’ lines to be proportionately reduced.” Therefore the Court concluded that because the J1 form contained a similar provision, it could reasonably be inferred that the full reinsurance clause was specifically referred to in the slip in case the NMA 1779 form was to be used⁶⁸. Incorporation was not the ratio of the Court of Appeal’s interpretation. Longmore LJ also noted “Rather than asking whether the reinsurance was intended to be back to back or whether the reinsurance was intended only to apply to loss and damage occurring within the policy period (affirmative answers could be given to both questions), it is probably better to ask whether the parties intended that, to the extent that they used the same or equivalent wording in the reinsurance as in the underlying insurance they intended that wording to have the same meaning in both contracts.”⁶⁹ Longmore LJ noted that this was not quite the same as asking merely whether the intention was back to back coverage because it was always possible that the reinsurance, while containing wording the same as or equivalent to that in the underlying contract, could contain wording relevant only to reinsurance⁷⁰. Turning to the original policy Lexington undertook to provide insurance “on property” as described “from the 1st day of July 1977 to the 1st day of July 1980 beginning and ending at noon”. The

⁶⁷ Weir, 218, 235.

⁶⁸ [2008] 1 CLC 340, 346.

⁶⁹ [2008] 1 CLC 340, 352.

⁷⁰ [2008] 1 CLC 340, 352.

reinsurance was on “all property of every kind and description and/or as original” for a period “36 months at date 1.7.77”. The period, although expressed in slightly different words, was thus effectively identical. The Washington Supreme Court based its decision on the words “all risks or physical loss...”, words also contained in the reinsurance agreement. Accordingly it does not matter whether the terms are warranted, as suggested by Weir, or whether the contracts are to be construed back to back: those words are to be given a common interpretation.

Longmore LJ also felt that even if *Vesta* and *Groupama* were to be distinguished, any distinction was of fact rather than principle⁷¹. The Court also pointed out that proration of damage only makes sense by reference to the existence of different periods of cover or different years of cover. Thus Longmore LJ accepted that the policy period was an important part of the policy’s construction Washington Supreme Court and adopted Merkin’s comment in *Ins LM* in October 2007 that “By accepting premium on the same basis as the reinsured, and by using words which were more or less indistinguishable from those in the direct policy, the arguments put forward by Lexington appear to have great cogency”.

Longmore LJ chose not to decide if facultative reinsurance was further insurance or liability insurance, because on either view the outcome would be the same. Phil LJ also did not express any opinion on the point. Sedley LJ, by contrast, emphasised the historical development of reinsurance and pointed out that since marine reinsurance had in its origins been regarded as a form of gambling, such contracts were banned in Great Britain by the Marine Insurance Act 1745 s.4 until the passing of the Revenue (No.2) Act 1864. Sedley LJ asserted that because of the ban -even though they were not forbidden- non-marine reinsurance contracts were ascribed to the insured risk rather than the to underlying insurance⁷². Sedley LJ distinguished the current reinsurance practice from the old tradition and stated that now the vocabulary and practice of reinsurance indicate that “what is reinsured is the insurer’s own liability”⁷³.

⁷¹[2008] 1 CLC 340, 357.

⁷² [2008] 1 CLC 340, 361-362.

⁷³ [2008] 1 CLC 340, 362.

It may be seen that if, as assumed by Simon J, facultative reinsurance is a further insurance on the original subject matter, the two contracts may be interpreted independently of each other according to their respective applicable laws, However the Court of Appeal did not adopt this view. In *Wasa* the Washington Supreme Court decided the case in reliance on the original policy terms, holding that the three-year period limitation did not preclude coverage for loss before or after that period. The reinsurance contracts contained no contrary provisions or exclusion, but were worded “as original”. Thus, the reinsurance contracts contained the same perils insured clause as the underlying policy, and the premium had been shared proportionately. It might have been argued that the Washington Supreme Court decision was manifestly perverse and accordingly not binding in establishing the reinsured’s liability⁷⁴ but no suggestion of that type was made⁷⁵. The point was that the Washington decision was unexpected and the question was whether the reinsurers should be bound by the outcome. The above analysis indicates that where the reinsurance contract is worded to all intents and identically to the underlying insurance, there is no reason why the reinsurance is to be construed differently from the original policy⁷⁶.

⁷⁴ There is authority to suggest that a “perverse” decision of a foreign court might not be regarded as binding: *Commercial Union Assurance Co plc v NRG Victory Reinsurance Ltd* [1998] 2 Lloyd’s Rep 600.

⁷⁵ In fact it is not clear what exactly “perverse” means; for the discussion see the second part of this thesis, Heading 5.2.1.

⁷⁶ See Merkin, “Back to Back Cover”, *Ins LM* October 2007 and Merkin, “The Construction of Facultative Contracts”, *Ins LM* June 2008, 4.

CHAPTER 2 THE FUNCTION OF THE OPENING WORDS OF THE FULL REINSURANCE CLAUSE

As mentioned above, in the London Market, facultative reinsurance contracts are formed by appending to the direct policy a cover page which states that reinsurance is on the same terms “as original”. The comments on the purpose of using that wording are not consistent, and the judicial view has not been settled although the bulk of authority holds that the phrase carries the terms of the insurance contract into the reinsurance agreement. Nevertheless, it might be thought that acceptance of this view has created unnecessary controversies and sometimes superfluous and confusing analysis⁷⁷. This chapter will consider the arguments.

2.1 Dispute That Incorporation is Not a Desired Aim

In the late nineteenth and early twentieth centuries an underwriter who insured risks in which he was not an expert would refer to other policies that had already been taken out on the same subject matter and against the same risk. Such contracts contained a typical clause worded as “warranted to be on the same rate, terms and identical interest of ...Insurance Company.” Such clauses were interpreted by the courts as conditions precedent to the liability of the underwriters that the terms of the later insurance contract were identical to the earlier policy referred to⁷⁸. As a result, disparities between the policies such as premium differences⁷⁹ or valuation of the policy⁸⁰ were held to be breaches of conditions precedent that relieved the insurers from liability⁸¹.

A similar attitude has been expressed in some modern reinsurance authorities where the full reinsurance clause was worded as “warranted same gross rate terms and conditions”. In *Vesta v Butcher*⁸² Lord Griffiths expressed his reluctance to read the phrase as effecting the incorporation of the original policy terms into the reinsurance contract. His Lordship’s

⁷⁷ Nicoll, “HIH Litigation”, (2003) 119 LQR 572, 581.

⁷⁸ *Barnards v Faber* [1893] 1 QB 340; *Bancroft v Heath* (1901) 17 TLR 425. However, see: *Walker & Sons v Uzielli* (1896) Com Cas 452; *The Sulphite Pulp Co Ltd v Faber* (1895-96) 1 Com Cas 146; *Beauchamp v Faber* (1898) 3 Com Cas 308.

⁷⁹ *Barnard v Faber*; *Walker & Sons v Uzielli*.

⁸⁰ *Bancroft v Heath*.

⁸¹ It should be noted that while classifying such clauses as conditions precedent to the liability of the underwriters, the courts did not give any importance to the word “warranted”.

⁸² [1989] 1 Lloyd’s Rep 331, 337. See also Kerr LJ’s speech in *Phoenix General Insurance v Halvanon Insurance* [1988] QB 216, 278.

view was that the clause amounted to a warranty given by the insurer that he had placed the risk on the same terms that he has disclosed to the reinsurers.

Although the majority of the House of Lords did not agree with Lord Griffiths and held that the clause incorporated the terms of the original policy into the reinsurance contract,⁸³ later authorities have accepted Lord Griffiths' assertion. For instance, in *AIG Europe (UK) Ltd. v Anonymous Greek Co of General Insurances, The Ethniki*⁸⁴ Colman J confined the function of the "as original" wording as ensuring that the substantive or subject-matter terms of the reinsurance, matched the substantive or subject-matter terms of the primary cover. In parallel with this argument it is possible to affirm that the reason for appending the direct policy may be no more than to confirm that reinsurers have seen and understood the scope of the direct policy.

Nevertheless as it appears that incorporation was seen as the intended objective from the early development of reinsurance law, and followed by the majority of modern reinsurance cases, it has become necessary to analyse requirements and scope of incorporation.

2.2 Development of the Theory of Incorporation

It seems that incorporation was seen as the intended objective from the early development of the reinsurance law⁸⁵. For instance, in *Re Eddystone Marine Insurance Co. ex parte. Western Insurance Co*⁸⁶, Joseph Walton QC stated in his address to the court that the policy containing the clause "Being a reinsurance...subject to the same terms and conditions as the original policy, and to pay as may be paid thereon" was in the usual form at Lloyd's. He stated that the original policy may have been effected at various places, and may not perhaps be at hand, or cannot be copied in, so the incorporation of the terms of the original policy was effected by the use of this form⁸⁷.

⁸³ Incorporation was indeed common ground between the parties, so the case proceeded on that basis.

⁸⁴ [1999] Lloyd's Rep IR 221, aff'd [2000] Lloyd's Rep IR 343; However in *Toomey v Banco Vitalicio De Espana SA de Seguros* [2004] Lloyd's Rep IR 354 the reinsurers relied on Lord Griffiths' speech in *Vesta*; nevertheless Andrew Smith J expressly rejected their contention.

⁸⁵ *The Imperial Marine Insurance Co. v The Fire Insurance Corp. Ltd.* (1879) 4 CPD 166. In truth, reinsurance appears to be as old as insurance itself. However reinsurance was declared to be illegal by s.4 of the Marine Insurance Act 1745 unless the insurer was insolvent, bankrupt or dead, a prohibition which lasted until the Revenue (No.2) Act 1864, s.1.

⁸⁶ [1892] 2 Ch 423, 425.

⁸⁷ [1892] 2 Ch 423, 425. The common nature of the form was also emphasised by Phillimore LJ in *Street v Royal Exchange Assurance* (1914) 19 Com Cas 339, 349.

There are also numerous modern authorities supporting this notion. For example, in *Toomey v. Banco Vitalicio De Espana SA de Seguros*, Andrew Smith J adopted the view that the clause “Being a reinsurance of and warranted the same gross rate, terms and conditions as ...” incorporated the terms of the direct policy into the reinsurance rather than creating a warranty that the underlying insurance was on identical terms to those disclosed to the reinsurance⁸⁸.

2.3 Requirements for Incorporation

The specific requirements of incorporation of the terms of the original policy into the reinsurance were laid down in *HIH Casualty & General Insurance Ltd v New Hampshire Insurance Co.*⁸⁹ Before considering these requirements some general principles should be considered. First, in a retrocession context, the wording “as original” refers to the primary insurance and not the reinsurance⁹⁰. Secondly, there is a question as to whether the reference is to the policy alone or other documents. In *American International Marine Agency of New York Inc v Dandridge*⁹¹ it was held that “original policy” meant the slip policy or the policy itself, but not other documents such as a binder which provided for the insurer’s participation in the cover. Thirdly, there will be no incorporation if the original insurance contract is itself incomplete at the time the reinsurance is made⁹².

As laid down in *HIH v New Hampshire*, incorporation of a particular clause depends upon the construction of the reinsurance as well as surrounding circumstances⁹³. A term can be incorporated from a direct policy into a reinsurance agreement if:

⁸⁸ On appeal the reinsurance contract was held to be voidable for misrepresentation. Thomas LJ who gave the only reasoned judgment in the Court of Appeal left open the meaning of the full reinsurance clause [2005] Lloyd’s Rep IR 423. See also Andrew Smith J’s *obiter* comment in *Prifti v Musini Sociedad Anonima de Seguros y Reaseguros* [2004] 1 CLC 517.

⁸⁹ [2001] 2 Lloyd’s Rep 161.

⁹⁰ *Pine Top Insurance Co. Ltd. v Unione Italiana Anglo Saxon Reinsurance Co.Ltd* [1987] 1 Lloyd’s Rep 476. However, in an earlier case, *General Insurance Co of Trieste Ltd v Corporation of the Royal Exchange* (1897) 2 Com Cas 144, both the reinsurance and retrocession contracts were “as original” and Mathew J recognised the incorporation of a term from the reinsurance into the retrocession.

⁹¹ [2005] Lloyd’s Rep IR 643.

⁹² For instance in *Cigna Life Insurance Co of Europe SA-NV v Intercaser SA de Seguros y Reaseguros* [2001] CLC 1356 the reinsurance slip provided that the reinsurance conditions followed those in the direct policy, and that other terms and conditions were as per the *Intercaser* Reinsurance Contract. However there was no such contract as referred to in the slip in existence at the time it had been entered into. See also *Excess Insurance Co Ltd v Mander* [1995] CLC 838.

⁹³ *American International Marine Agency v Dandridge* [2005] Lloyd’s Rep IR 643.

- the term was germane to the reinsurance;
- the term made sense, subject to permissible “manipulation”, in the context of the reinsurance;
- the term was consistent with the express terms of the reinsurance, and
- the term was apposite for inclusion in the reinsurance.

It is now settled that the phrase “all terms and conditions as original” is not to be read as comprising “all” terms of the original policy⁹⁴. More explicitly, the terms germane to reinsurance are confined to those provisions defining the period, the geographical limits and the nature of the risk undertaken by the reinsurer⁹⁵. Further, the incorporation clause is not to be interpreted as encompassing clauses which are inconsistent with the reinsurance agreement⁹⁶. Even if a clause complies with other requirements, incorporation is not allowed to the extent that it contradicts the express provisions of the reinsurance⁹⁷. It is also permissible to incorporate a term which refers to, eg, the “insurer” by manipulating it to read “reinsurer”⁹⁸. What is permissible by way of manipulation is considered below.

2.4 The Scope of Incorporation

It is now settled that the incorporation wording does not encompass all of the provisions of the original insurance contracts. The established factors determining which terms may be incorporated are as follows.

2.4.1 Incorporation of Unusual Terms

The position under general contract law is that a clause with an onerous or unusual nature cannot be regarded as incorporated unless the party relying on it proves that he drew the other party’s attention to it⁹⁹. In the reinsurance context it has been established that clauses that in common use can be incorporated¹⁰⁰.

⁹⁴ *Pine Top v Anglo Saxon Reinsurance; Municipal Mutual Insurance Ltd v Sea Insurance Co Ltd* [1996] CLC 1515, 1527.

⁹⁵ *Pine Top v Anglo Saxon Reinsurance*.

⁹⁶ *Municipal Mutual Insurance Ltd v Sea Insurance Co Ltd; Home Insurance Company of New York v Victoria – Montreal Fire Insurance Company* [1907] AC 59.

⁹⁷ *Australian Widows’ Fund Life Assurance Society, Ltd v National Mutual Life Association of Australasia* [1914] AC 634; *MacGillivray on Insurance Law*, para 33-62.

⁹⁸ *CNA International Reinsurance Co Ltd v Companhia de Seguros Tranquilidade SA* [1999] CLC 140.

⁹⁹ *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* [1989] QB 433. See also *Henderson v Stevenson* LR 2 Sc & Div 470; *Thornton v Shoe Lane Parking Ltd* [1971] 2 QB 163.

¹⁰⁰ *Marten v The Nippon Sea and Land Insurance Co. Ltd* (1898) Com Cas 164; *Charlesworth v Faber* (1900) 5 Com Cas 408; but see *Franco Hungarian v Merchants Marine Insurance*, Shipping Gazette, June 7, 1888.

A modified approach was adopted in *HIH v New Hampshire*, where the reinsured expressly waived its right to rely on breach of duty of disclosure by the assured, and the question was whether this clause was carried into the reinsurance contract. At first instance David Steel J accepted expert evidence to the effect that such clauses were often requested and “sometimes agreed”; hence were not unconscionable or extortionate. This led the trial judge to hold that the waiver of defences clause was not standard or customary, but in no sense unique, and that in all the circumstances it was fair to regard it as incorporated¹⁰¹.

It has been suggested that the effect of an unusual clause might be assessed in terms of good faith¹⁰². If the original policy contains a clause which the reinsurer could not have expected to find, the reinsured would be bound by the rules of disclosure to bring the clause to the reinsurer’s attention as a material fact in pre-contract disclosure, because the reinsurer is entitled to expect the reinsurance to be in usual form¹⁰³. Thus, the reinsurer may be entitled to avoid the contract in the absence of disclosure¹⁰⁴. In *HIH v New Hampshire*¹⁰⁵ Rix LJ accepted, *obiter*, that the appropriate question was not whether there had been incorporation, but whether the reinsured had broken its duty of disclosure in relation to the unusual clause in the original policy.

Incorporation of unusual terms may also lead to an extension of the reinsurer’s liability beyond its agreed scope. A typical example is the purported incorporation of a held covered clause from the original insurance into a reinsurance policy whose period of cover

¹⁰¹ [2001] 1 Lloyd’s Rep 378, 387. David Steel J (Rix LJ agreed [2001] 2 Lloyd’s Rep 161, para 207) distinguished *Marten v The Nippon Sea and Land Insurance* and *Charlesworth v Faber* because they were only authority for the proposition that reinsurers are bound by usual terms even to the extent of overriding an inconsistency, and that whether general words of incorporation can import an unusual or uncommon term “is quite a different question”.

¹⁰² Butler and Merkin, para B-0124; *MacGillivray on Insurance Law*, para 33-57. In contract law, in *Interfoto v Stiletto* Bingham LJ gave some indication of his willingness to rely on the civil law good faith principle in formation of contracts. However, see *Star Steamship Society v Beogradska Plovidba, The Junior K* [1988] 2 Lloyd’s Rep 583.

¹⁰³ *Maritime Insurance v Stearns* [1901] 2 KB 912. See *Axa v Ace Global Markets* [2006] Lloyd’s Rep IR 683 where in approving incorporation of standard market wordings into the reinsurance contract, Gloster J took into consideration that although the wording of EXEL 1.1.90 was not attached to the slip, it was clear from the express terms of the slip that the authors of it clearly had the EXEL 1.1.90 wording in front of them when drafting the slip or alternatively, it was clear that they were extremely familiar with its provisions.

¹⁰⁴ See *Property Insurance Co v National Protector Insurance Co*, (1913) Com Cas 119, 122 where Scrutton J stated that an unusual clause might be a material fact which ought to have been disclosed.

¹⁰⁵ [2001] 2 Lloyd’s Rep 161, 199; See *Charlesworth v Faber* where the reinsurer unsuccessfully relied on the unusual nature of the clause in arguing that he was entitled to avoid the contract.

is expressly limited. Evidence that a held covered clause was commonly used in the particular form of insurance would give a strong argument that the reinsurer could be assumed to have been aware of the existence of the clause, and his liability would be extended beyond the terms of the reinsurance¹⁰⁶.

In the general law of contract, market evidence may be used to determine whether the clause is of a usual nature, in other words whether a reasonable person should expect its existence. In *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd*, the Court looked at the rates of ten other firms and found that none of them charged as much as *Interfoto*. If both parties work in the same business, it is somewhat easier to determine whether a clause could be expected to be found in the contract in question¹⁰⁷. In the same way, in reinsurance cases, other similar contracts may be evidence as to whether the reinsurer should have expected the existence of such a clause in the insurance policy, as in *HIH v New Hampshire*¹⁰⁸.

2.4.2 Incorporation of Inconsistent Terms

2.4.2.1 Construction of Inconsistent Terms

While the Courts' view was mechanical in the old authorities¹⁰⁹, their attitude has changed and the current position is that conflicting incorporated terms are disregarded if they are incapable of being given a sensible meaning in the context, although the Courts will seek to give effect to them if the conflicting clauses can live together¹¹⁰. The reason for this principle is that in the ordinary course of events the parties may be assumed to have given express consideration to written terms and much less, if any, consideration to the application of the incorporated terms¹¹¹.

¹⁰⁶ In *Charlesworth v Faber* Bingham J accepted incorporation of a held covered clause into the reinsurance policy as such a provision was not unusual.

¹⁰⁷ Per Bingham LJ, in *Interfoto*, at 445.

¹⁰⁸ [2001] 1 Lloyd's Rep 378, 287.

¹⁰⁹ See *Doe & Leicester v Biggs*, (1809) 2 Taunt 109, 113 where Mansfield CJ held stated that "the general rule is, that if there be a repugnancy, the first words in a deed, and the last words in a will, shall prevail".

¹¹⁰ *Finagra Ltd v OT Africa Ltd* [1998] 2 Lloyd's Rep 622; *Metalfer Corporation v Pan Oceanhipping Co Ltd* [1998] 2 Lloyd's Rep 632; *Sabah Flour and Feedmills Sdn Bhd v Comfez Ltd*. [1988] 2 Lloyd's Rep 18. *Quinta CommunicationSA v Warrington* [2000] Lloyd's Rep IR 81. In *Adamastos Shipping v Anglo-Saxon Petroleum* [1959] AC 133 the charterparty incorporated the US "Paramount Clause". The clause was worded as "This bill of lading shall have effect subject to... the Carriage of Goods by Sea Act of the United States... 1936...". The House of Lords unanimously held that it did not make sense to begin a clause of a charterparty with the words "This bill of lading"; therefore on the true construction of the charterparty the Paramount Clause must be read as if it was "This charterparty shall have effect...".

¹¹¹ It is much the same principle whereby typed clauses prevail over printed clauses and handwritten clauses will ordinarily prevail over typed clauses. See *Farmers' Co-op Ltd. v National Benefit Assurance Co.* (1922)

2.4.2.2 Inconsistency between Reinsurance – Insurance Contracts

In some early cases the independence of reinsurance and insurance contracts was recognised, and each was construed in accordance with its own terms. For instance, in *Franco-Hungarian v Merchants Marine Insurance*¹¹² the direct policy contained a held covered clause, whereas the retrocession policy did not, and the reinsurance was “as original”. Day J stressed that incorporated provisions operated only until the retrocession cover ended, according to its own term.

Nevertheless, in *Marten v The Nippon Sea and Land Insurance*¹¹³ Bigham J read the full reinsurance clause as extending the reinsurance cover beyond that stated in the reinsurance. In this case the issue was related to the physical limits of cover: the insurance covered the risk from warehouse to warehouse while the reinsurance was stated to be “from loading ...until ...safely landed at ...port”. The goods were damaged in the customs warehouse after being discharged from the ship. Bigham J held that because of the commonplace nature of the clause, it was carried into the reinsurance contract. Similarly, in *Charlesworth v Faber*¹¹⁴ the issue once again was the unusual character of the held covered clause, but Bigham J ruled that a held covered clause was in common use in connection with that particular kind of time policy on liners. He distinguished *Franco-Hungarian* by asserting that in *Franco* no evidence appeared to have been given to show that the clause was well known and in common use. It has been asserted that Bigham J’s reason is unconvincing¹¹⁵ because in *Franco* Day J did not mention the degree of any use of the relevant clause and his decision was based on the point that incorporation would have extended the reinsurer’s liability beyond that for which he actually contracted. It is unfortunate that the inconsistency between the terms of the insurance and reinsurance contracts was not taken into account by Bigham J and the learned judge did not give any weight to the terms of the reinsurance policy indicating the limited period of the reinsurance cover. It can be deduced from Bigham J’s conclusions that if an inconsistency appears, the original insurance provisions can override the terms of the reinsurance regardless of the independence of these contracts from each other. Consequently, those

13 Ll LR 530, 533 *per* Atkin LJ; *City Tailors Ltd v Evans* (1921) 9 Ll LR 394; *The Ion*, [1971] 1 Lloyd’s Rep 541.

¹¹² Shipping Gazette, June 7, 1888.

¹¹³ (1898) Com Cas 164.

¹¹⁴ (1900) Com Cas 408, 412. However the case was ultimately decided on the basis that the reinsurance was unenforceable under the Stamp Act 1891 as it was made for a longer period than twelve months.

¹¹⁵ Butler and Merkin, para B-0130.

authorities show that if a term of the original insurance is common in nature, the full reinsurance clause may carry it into the reinsurance, thereby extending the reinsurer's liability beyond his own contractual terms.

It is noteworthy that in *Joyce v Realm Marine Insurance Co.Ltd*¹¹⁶, Blackburn J disregarded an express discrepancy between the provisions of reinsurance and insurance agreements. Here, the original insurance contained an extension clause providing that "outward cargo to be considered homeward interest twenty-four hours after her arrival at her first port of discharge". The reinsurance policy which was affected after the vessel had arrived in Africa (outward destination) did not mention the extension clause and provided cover "from the loading thereof and thereafter while the cargo was being conveyed between African ports and on its homeward voyage". The cargo was damaged after the vessel arrived at an African port and at a time when the cargo had remained on its outward journey for more than twenty-four hours. Blackburn J was of the view that the incorporation wording permitted him to use the original policy terms as evidence to construe the reinsurance provisions. Consequently "from the loading thereof" was interpreted as covering constructive loading, in line with the original insurance. Interestingly, this case pre-dated *Franco Hungarian* in which the independence of the reinsurance contract was emphasised. However *Franco* is so poorly reported that it is not clear whether Day J distinguished *Joyce*¹¹⁷.

In *Joyce*, Blackburn J referred to *Bell v Hobson*¹¹⁸ where in fact incorporation was not the issue and the concern was construction of marine policy terms. Lord Ellenborough stated that where an insurer's liability in respect of marine cargo is expressed as commencing "from the loading on board", the phrase is to be confined to the place from whence the risk commenced. He also added that if there was anything to indicate that a prior loading was contemplated by the parties, it will release the case from that strict construction¹¹⁹. Blackburn J adopted Lord Ellenborough's view but modified, to the effect that bringing the construction of the terms of the original policy into the reinsurance contract by virtue

¹¹⁶ (1871-72) LR 7 QB 580.

¹¹⁷ Butler and Merkin, para B-127. The authors also submitted that *Joyce* did not create a general rule and applies only to the particular facts of the case.

¹¹⁸ (1812) 16 East 240.

¹¹⁹ (1812) 16 East 240, 243.

of the full reinsurance clause was possible. It may be assumed that if there had been no words of incorporation, the decision in *Joyce* could have been different¹²⁰.

In *Stronghold Insurance Co Ltd v Bulstrad Insurance and Reinsurance plc*¹²¹ the reinsurance contained the words: “all settlements made by the Company shall be binding on their Reinsurers and the Reinsurers agree to pay to the Company any amounts that may be recoverable under this Agreement within 15 (fifteen) days after the receipt of the necessary papers proving the loss.” The retrocession agreement stated “all clauses terms and conditions as original insofar as applicable and to pay as may be paid thereon.” The reinsurer argued that the effect of the “all clauses terms and conditions as original” wording in the retrocession was to incorporate the “follow the settlements” clause into the retrocession. The latter clause overrode the “pay as may be paid thereon” clause so that, without proving actual liability, the reinsurer could make a claim against the retrocessionaire where the reinsurer acted in a bona fides and businesslike manner. HHJ Mackie QC applied the requirements of incorporation laid down in *HIH v New Hampshire Insurance* and held that “pay as may be paid” and “follow the settlements” clauses produced opposite results so that the two clauses were inconsistent each other and the latter could not be incorporated into the retrocession agreement.

It is suggested that, while examining the effect of the incorporation wording on construing inconsistent terms, it is crucial to bear in mind that reinsurance and insurance contracts should be read according to their own terms as they are independent from each other¹²². In other words, where the parties to the reinsurance made a specific agreement, this should not be disregarded¹²³. Obviously, problems are sidestepped if it is accepted that the “as original” wording has no function other than confirming that the terms of reinsurance match the original policy unless the parties agree otherwise. Moreover, even if the incorporation purpose is accepted, the Privy Council’s declaration in *Australian Widows’*

¹²⁰ It is seen in some recent authorities that the full reinsurance clause has been construed in similar understanding to *Joyce*. For example in *Vesta v Butcher* [1989] 1 Lloyd’s Rep 331 the majority of the House of Lords gave the warranty in the reinsurance contract a meaning in the same way as of the original insurance. Furthermore, in *Groupeama Navigation et Transports & Ors v Catatumbo Seguros* [2000] 2 Lloyd’s Rep 350, the Court of Appeal held that the inconsistency should be overcome by construing the reinsurance terms in the same way as of the direct policy. It should nevertheless be noted that in both cases the back to back presumption underlay the decisions. That presumption and these cases are examined in detail below.

¹²¹ Unreported, see the March 2008 issue of *Insurance Law Monthly*.

¹²² See O’Neill and Woloniecki para 1-35 where independent feature of these two contracts is emphasised.

¹²³ *Heath Lambert Ltd v Sociedad de Corretaje de Seguros* [2004] Lloyd’s Rep IR 905.

*Fund v. National Mutual*¹²⁴ has made it clear that “subject to the same terms and conditions as original” should be construed as if it were prefaced with the words “except as herein otherwise provided”.

2.4.3 Incorporation of Claims Clauses

In considering the possibility of incorporation, it is necessary to look at whether the term is potentially applicable in the reinsurance context. For instance, a time bar clause that requires the assured to make a claim in 12-month period running from the date of loss cannot be applied to claims made by the reinsured against the reinsurer, because a reinsurance loss differs from the direct loss. The consideration that such clauses cannot make sense in the reinsurance context led the Privy Council in *Home Insurance v Victoria – Montreal* to hold that the time bar clause was not applicable to claims under a retrocession contract. Although the scope of the full reinsurance clause was not the issue, the Privy Council’s reasoning is equally applicable when incorporation is under consideration¹²⁵.

A different approach may be arguably justified in respect of claims co-operation clauses. Under liability policies, and particularly those written on a claims made basis, underwriters specify that they are to be informed of all circumstances that may give rise to claims against them, and also that the assured is not to incur any expense without their assent. Accordingly, in *British General Insurance Company Ltd. v Mountain* the Lord Chancellor stated that the interest of the insurer in being kept closely informed of the making and development of claims was equally applicable to the relationship between reinsurer and reinsured¹²⁶.

On the other hand, in *Municipal Mutual Insurance Ltd v. Sea Insurance Co Ltd*¹²⁷, Waller J found that a clause requiring the assured to seek the insurer’s written consent prior to incurring legal costs was inapt to the reinsurance contract and he held that in the absence of compelling words in the reinsurance policy, was not to be regarded as incorporated into

¹²⁴ [1914] AC 634, 642.

¹²⁵ Butler and Merkin, para B-0138.

¹²⁶ (1919) 1 Ll LR 605. In this case the original insurance contained a clause which required the assured not to incur any expense without consent of the underwriters and the reinsurance policy was subject to the same terms and conditions as original. However, no mention was made of any incorporation or back-to-back point.

¹²⁷ [1996] CLC 1515. This case subsequently went to the Court of Appeal on other grounds.

it. The sense of this approach is illustrated by the judgment of Clarke J in *CNA International Reinsurance Co Ltd v Companhia de Seguros Tranquilidade SA*¹²⁸, where something akin to a rewriting of the contract could be discerned, although the decision was based on very clear and careful analysis. In this case a problem arose as to the meaning of a clause incorporated into the direct policy which stated, as translated, “This contract shall be subject to control claim if a claim arises”. Accepting the incorporation of this provision into the reinsurance¹²⁹, Clarke J found it appropriate to manipulate the word “insurer” as referring to “reinsurer”. He also described the clause in the direct insurance context as “obscure”; nevertheless the learned judge was convinced that the draftsman of the policy must have intended the claim to be controlled by someone and the only reference in the context was the reinsurer who took over 90% of the risk. Moreover, Clarke J took into account the fact that reinsurance and insurance contracts were assumed to provide back-to-back cover; therefore the terms of the reinsurance were to be interpreted in a way to fit the reinsurance although they were originally drafted for the purposes of insurance.

It should be pointed out that this discussion might have been avoided by accepting that reinsurers reinsure the liability of the reinsured under the original insurance contract. In that case, if the assured is in breach of a claims condition, and assuming that the term is a condition precedent, the insurer would be relieved from liability to the assured; as a result the reinsurer’s liability would not arise either. Accepting the contrary view resulted in a complex and unnecessary discussion.

2.4.4 Incorporation of Implied Terms

It is accepted in contract law that terms may be implied in fact, law or custom, where express terms do not deal with every aspect of performance of the contract¹³⁰. The question is whether an implied term of the original insurance is to be incorporated into the

¹²⁸ [1999] CLC 140.

¹²⁹ “As original” wording was not the issue, but the reinsurance slip incorporated various wordings and also provided under the heading “interest” that the policy was to indemnify the assured for loss in the event of the cancellation of the concert. Clarke J accepted the argument that the interest clause was a reinsuring provision in its own right which had the effect of incorporating the underlying wording.

¹³⁰ Unless the parties expressly excluded it. *Liverpool City Council v Irwin* [1977] AC 239, per Lord Cross at 257-258. For detailed information about implied terms see Butterworth’s Law of Contract, 3rd ed, Professor Michael Furmston with special editors, para 3.19 et seq.

reinsurance policy by means of the full reinsurance clause¹³¹. On one hand the presumption of back-to-back cover seems to make incorporation of implied terms acceptable; on the other, it is possible to contend that the purpose of appending the original slip or policy to the reinsurance contract is to ensure that the reinsurer has seen the terms of the insurance and is aware of the nature of his risk. In *HIH v New Hampshire*¹³² David Steel J expressed the view that implied terms would be incorporated into the contract of reinsurance. However it should be taken into consideration that the reinsurer cannot see the implied term while examining the original policy before signing the slip. As was stated above, onerous or unreasonable terms have been held not to be incorporated unless they had been notified to the reinsurers. Likewise, it would not be fair to compel the reinsurer to be bound by terms that were not apparent at the time the reinsurance contract was made.

2.4.5 Incorporation of Arbitration Clauses

2.4.5.1 Incorporation from Charterparty into Bills of Lading

It is settled law that a general incorporation clause only carries terms which are “germane to . . . the proper subject matter” of the incorporating contract, namely the clauses related to the receipt, carriage, or delivery of the cargo or the payment of freight¹³³. An arbitration clause governs dispute resolution and is not relevant to the performance of the contract of carriage; it takes effect as a self-contained contract collateral to the substantive agreement¹³⁴. As a result, because of the ancillary and separable nature of an arbitration clause, unless it is clearly and expressly provided, general words of incorporation do not operate on it¹³⁵.

¹³¹ Recently, a few insurance cases have recognised implied terms: *Goshawk Dedicated Ltd v Tyser & Co Ltd* [2007] Lloyd’s Rep IR 224. In reinsurance context see *Phoenix General Insurance Co of Greece S.A. v Halvanon Insurance Co.Ltd* [1985] 2 Lloyd’s Rep. 599, but contrast the restrictive view adopted in *Bonner v Cox* [2006] Lloyd’s Rep IR 385.

¹³² [2001] 1 Lloyd’s Rep 378.

¹³³ *Wilson, Carriage of Goods By Sea*, 242; See, eg: *The Varenna* [1983] 2 Lloyd’s Rep 592; *The Annefield* [1971] 1 Lloyd’s Rep 1.

¹³⁴ *Bremer Vulkan Schiffbau und Maschinenfabrik v South India Shipping Corporation Ltd.* [1981] AC 909; *Heyman v Darwins* [1942] AC 356; *Black Clawson Internatiol Ltd. v Papierwerke Waldhof-Aschaffenburg A.G.* [1981] 2 Lloyd’s Rep 446; *Harbour Assurance Co. (U.K.) Ltd v Kansa General International Insurance Co. Ltd* [1993] QB 701.

¹³⁵ *Hamilton and Co. v Mackie and Sons* (1889) 5 TLR 677; *Thomas & Co Ltd v Portsea SS Co Ltd* [1912] AC 1; *The Elizabeth H* [1962] 1 Lloyd’s Rep 172; *The Njegos* [1936] P 90; *Federal Bulk Carriers Inc. v Itoh & Co. Ltd.* [1989] 1 Lloyd’s Rep 103. For incorporation clauses that expressly referred to the arbitration clause into charterparties: see *The Rena K* [1978] 1 Lloyd’s Rep 545; *The Oinoussin Pride* [1991] 1 Lloyd’s Rep 126; *The Nerano* [1996] 1 Lloyd’s Rep 1; *The Delos* [2001] 1 Lloyd’s Rep 703; Merkin, *Arbitration Law* paras 5.19 to 5.33; Todd, “Incorporation of Arbitration Clauses into Bills of Lading” [1997] JBL 331.

2.4.5.2 Incorporation from Direct Insurance into Reinsurance Contracts

In *Pine Top v Anglo Saxon Reinsurance* the main purpose for rendering the reinsurance on the same terms as original was explained as being the provision of matching cover. For that reason, only the terms defining the period, geographical limit and the nature of the risk were held to be carried across, and an arbitration clause was held not to have been incorporated. The arbitration clause was classified as ancillary or collateral to the contract of reinsurance. This proposition is now well established¹³⁶.

Incorporation of terms from the direct policy should be distinguished from incorporation of terms from other sources, such as standard market wordings¹³⁷. In the latter case problems may arise from inconsistency between the standard terms and the express terms of incorporating contract which the court will be required to resolve. For instance in *Axa v Ace Global Markets*¹³⁸ the reinsurance was on “Full wording as EXEL 1.1.90”. Gloster J found it possible to reconcile the arbitration clause in standard EXEL wording with the English choice of law and jurisdiction clause in the reinsurance slip by holding that the latter related to supervision of the arbitration and challenges to any award and, accordingly held that the arbitration clause was incorporated with other standard clauses in EXEL 1.1.90.

2.4.5.3 The Arbitration Act 1996 section 6(2)

Pine Top and *Excess Insurance v Mander* pre-dated the Arbitration Act 1996. Section 6(2) of the Act provides that “the reference in an agreement to a written form of arbitration clause or to a document containing an arbitration clause constitutes an arbitration agreement if the reference is such as to make that clause part of the agreement”. The wording of the section seems to allow the incorporation of an arbitration clause from one document into another via general words of incorporation¹³⁹. The Departmental Advisory Committee on Arbitration Law (DAC) report paragraph 42 left the issue to the courts to decide, and was taken into consideration by Raymond Jack QC that this was a field that

¹³⁶ *Excess Insurance v Mander*; *American International Speciality Lines Insurance Co. v Abbott Laboratories* [2003] 1 Lloyd’s Rep 267; *Cigna Life Insurance v Intercaser*; *OK Petroleum A.B. v Vitrol Energy S.A.* [1995] 2 Lloyd’s Rep 160.

¹³⁷ For instance in *CNA International Reinsurance v Companhia de Seguros Tranquilidade SA* Clarke J found that incorporation of terms from standard market wordings was inevitable; otherwise there would be no terms of reinsurance.

¹³⁸ [2006] Lloyd’s Rep IR 683.

¹³⁹ Hunter and Landau, *The English Arbitration Act 1996: Text and Notes* 1998, fn.20.

the law should be clear, certain and well understood; therefore the Arbitration Act s.6(2) did not change the settled view¹⁴⁰.

2.4.6 Incorporation of Jurisdiction and Choice of Law Clauses

Just as in the case of arbitration clauses, jurisdiction clauses are also defined as free-standing provisions because they are related to resolving disputes rather than to the performance of the contract¹⁴¹. Likewise, they are to be classified as ancillary provisions which the parties to the reinsurance would not normally intend to incorporate¹⁴². Such clauses in direct insurance have nothing to do with defining the risk; thus they are wholly inappropriate to disputes arising between the parties to the reinsurance contract¹⁴³. It is settled that a jurisdiction clause is not incorporated unless there is express reference to it in the reinsurance agreement¹⁴⁴. The position at common law has been extended to determination of the validity of jurisdiction clauses in EC cases under Art 23 of the Brussels Regulation¹⁴⁵, which requires consensus to be clearly demonstrated¹⁴⁶.

The same considerations have been taken into account in terms of incorporation of choice of law clauses¹⁴⁷. Under article 3.1 of the Rome Convention¹⁴⁸, a choice of law must be expressed or demonstrated with reasonable certainty, and a general incorporation provision is not to be regarded as having that effect. The position will be even more clearly stated when the Rome I Regulation¹⁴⁹ comes into force on 17 December 2009 to

¹⁴⁰ *Trygg Hansa Insurance Co. Ltd. v Equitas Ltd* [1998] 2 Lloyd's Rep 439, applied in *Cigna Life Insurance v Intercaser*.

¹⁴¹ *Excess Insurance v Mander; Trygg Hansa Insurance Co. Ltd. v Equitas Ltd*.

¹⁴² *Assicurazioni Generali SPA v Ege Sigorta AS* [2002] Lloyd's Rep IR 480; The expression "all terms whatsoever" does not change the position: *Siboti K/S v BP France SA* [2003] 2 Lloyd's Rep 364.

¹⁴³ *The Ethniki*; Aikens J in *Dornoch Ltd v Mauritius Union Assurance Co Ltd* [2006] Lloyd's Rep IR 127, aff'd [2006] Lloyd's Rep IR 786.

¹⁴⁴ *The Ethniki*. See also Hemsworth, "United Kingdom insurance decisions 2000", [2001] LMCLQ 513; cf *In K.H. Enterprise v Pioneer Container* [1994] 2 AC 324 (a bill of lading case). See also: Joseph, *Jurisdiction and Arbitration Agreements and Their Enforcement*, para 5.02; *ARIG Insurance Co. Ltd v SASA Assicurazione Riassicurazione SpA* (unreported, see Barlow Lyde & Gilbert, *Reinsurance Practice and The Law*, para 8-26).

¹⁴⁵ Council Regulation 44/2001.

¹⁴⁶ *AIG Europe S.A. v QBE International Insurance Ltd.* [2001] 2 Lloyd's Rep 268; *The Ethniki*; *Salotti v RUWA Polstereimaschinen GmbH* (Case 24/76) [1976] ECR 1831. A similar understanding adopted in terms of Art 23 of the Brussels Regulation; see *Siboti K/S v BP France SA*, applied by Andrew Smith J in *Prifti v Musini Sociedad Anonima de Seguros y Reaseguros* [2004] 1 CLC 517, 524.

¹⁴⁷ *Gan Insurance v Tai Ping Insurance (No.1)* [1999] Lloyd's Rep IR 472.

¹⁴⁸ Convention on the Law Applicable to Contractual Obligations opened for signature in Rome on 19 June 1980 (80/934/EEC).

¹⁴⁹ Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I).

contracts concluded after the same date, as article 3.1 that Regulation requires any choice of law to be expressly or clearly demonstrated, which is by its terms a stricter test¹⁵⁰.

¹⁵⁰ See Merkin, “The Rome I Regulation and Reinsurance”, (2009) 5 JPIL 69.

CHAPTER 3 IMPLICATIONS OF INCORPORATION

3.1 Waiver of Defences Clause in the Original Insurance

It is difficult to see sometimes how a clause which is perfectly appropriate to a direct policy can operate between the parties to the reinsurance contract. An illustration of this is *HIH Casualty & General Insurance Ltd v New Hampshire Insurance Co*¹⁵¹ which raised the position of a waiver of defences clause by which the direct insurer waived its right of disclosure from the assured and of avoidance in case of misrepresentation. At first instance¹⁵², David Steel J followed the analysis of Clarke J in *CNA International Reinsurance Co Ltd & Ors v. Companhia de Seguros Tranquilidade SA*¹⁵³ and held that the provision in question could be incorporated in its manipulated form, namely the word “insurer” could be read as referring to the “reinsurer”. Accordingly, the term was incorporated into the contract of reinsurance, operating as waiver of defences between the reinsurer and the reinsured. The Court of Appeal disagreed with that construction. Rix LJ, delivering the leading judgment held that the judge’s conclusion did not answer the question of what the provision actually achieved as a term in the reinsurance agreement¹⁵⁴. If the clause was incorporated in its manipulated form, it would mean that any separate breach of duty by the reinsured would be waived by reason of the independent operation of the clause in reinsurance context. Moreover, incorporation in its manipulated form did not achieve back-to-back cover. Rix LJ expressed the view that the clause made perfectly good sense in its unmanipulated form as it operated as a follow the settlements provision. By that provision, reinsurers undertook to follow the reinsured’s settlements so long as they were bona fide and businesslike. When the reinsured, who contractually waived his rights to rely on breach of the duty of utmost good faith, made payment to the assured in circumstances where he would otherwise have had a good faith defence, the reinsurer would be obliged to indemnify the reinsured for the reason that he recognised such payment by the incorporation of the waiver of defences clause.

The judgment of Rix LJ is significant in distinguishing the fact of incorporation and the effect of incorporation. Accordingly, while incorporation can be achieved by means of the “as original” wording, the incorporated clause may not create new rights between insurers

¹⁵¹ [2001] 2 Lloyd’s Rep 161.

¹⁵² [2001] 1 Lloyd’s Rep 378.

¹⁵³ [1999] CLC 140.

¹⁵⁴ [2001] 2 Lloyd’s Rep 161.

and reinsurers. The function of incorporation can be described as merely recognition of the effect of the clause in the direct policy and the clause may operate as no more than a follow the settlements provision.

3.2 Alterations to the Original Policy

The original insurance may be replaced with a fresh policy after the reinsurance has been effected. In such a case the question would be whether the new policy terms are covered by the phrase “original policy or policies” in the general words of incorporation. In *Lower Rhine and Württemberg Association v Sedgwick*¹⁵⁵ the phrase “the original policy or policies” was held to embrace only the direct policy in existence at the time that the reinsurance contract was made. However, the phrase may cover the replacement policy if its provisions are not materially different from that of the previous agreement¹⁵⁶. This principle was applied in *Scottish National Insurance v Poole*¹⁵⁷ where the loss of the infamous *Titanic* was in issue. In this case two steamships, the *Titanic* and the *Olympic*, were insured in January 1911 while in shipyard for a period of twelve months after delivery. Following the original insurance, reinsurance and retrocession contracts had been effected. The *Olympic* was delivered in May 1911 but the *Titanic* was not delivered until April 1912. As it had not been at risk until after the twelve-month period ended, another policy was issued in January 1912 upon the same terms as the January 1911 policy. When the *Titanic* was lost shortly after her delivery in April 1912, the issue was whether the second policy issued in January 1912 cancelled the preceding year’s slip, so that there remained nothing in force to which the reinsurance could attach. Bray J’s answer to this question was in the negative and he emphasised that even if that had been the case, the result would not have changed as the two policies were not materially different from each other¹⁵⁸.

¹⁵⁵ [1899] 1 QB 179 where the incorporation clause provided that “a reinsurance of policies [the following portion being left blank] and subject to the same terms, conditions and clauses as the original policy or policies...”.

¹⁵⁶ In *Sedgwick*, revaluation of the old original policies had been found to be a material change that did not bind the reinsurers. However see *North Star Shipping Ltd and others v Sphere Drake Insurance plc and others (No 2)* [2006] 2 Lloyd’s Rep 183 where valuation of the subject matter insured was found an immaterial fact in terms of the assured’s duty of disclosure. Kiln, *Reinsurance in Practice*, 12.

¹⁵⁷ (1912) Com Cas 9.

¹⁵⁸ (1912) Com Cas 9, 15. *Emanuel v Andrew Weir* (1914) 30 TLR 518 also based on the same facts but the parties were different. In this case the reinsurer issued the policy after the *Titanic* was lost and in order to make the *Sedgwick* case applicable the reinsurer stated in the policy that the original policy meant the policy initialled in January 1911. The judge applied *Scottish v Poole*, and held that when the second slip was initialled in January 1912 a suggestion was made that the insurance on the second slip should be treated so far as the *Titanic* was concerned, not as a renewal but a confirmation of the original 12 months. However, as

In addition to the replacement of the original policy, the same problem arises when the original terms have been modified without making a fresh contract. This was the point at stake in *Norwich Union Fire Insurance Society Ltd v Colonial Mutual Fire Insurance Co Ltd*¹⁵⁹ where the subject matter of insured was revalued without issuing a fresh policy. McCardie J rejected the argument that the *Sedgwick* case should be distinguished, as the original policy under which the reinsurer agreed to provide indemnity remained in force despite the revaluation of the subject matter insured. The learned judge recognised that alteration of the direct policy without the consent of the reinsurer would throw the reinsurer into a position of danger, difficulty and doubt¹⁶⁰. Moreover “valued as original policy” referred to the valuation in the original policy in respect of which the reinsurance was obtained and it was not to be interpreted “as valued in the original policy as amended from time to time”. Therefore he held that the materially changed policy was not the same as the original policy that the reinsurer had contracted.

Consequently, it is now settled that a materially modified primary insurance contract, either by issuing a new policy or alteration of the original policy terms only, is not counted as the original policy within the meaning of the full reinsurance clause.

Such disputes can always be avoided by an express term in the reinsurance contract which requires the reinsured to consult the reinsurers and obtain their consent to all amendments to the terms of the direct policies. In *HIH v New Hampshire* when classifying such a clause as “warranty” David Steel J declared that this provision gave contractual substance to the principle established by the abovementioned authorities¹⁶¹.

3.3 Alterations to the Original Policy and the Continuing Duty of Utmost Good Faith

It may be asked whether amendments to the original policy without the reinsurer’s consent amount to a breach of the continuing duty of utmost good faith on the part of the reinsured. Two issues need to be considered. The first is whether the duty of utmost good

opposed to the approach of Bray J, the judge construed the first policy as coming into force on 18 May 1911, when the *Olympic* came under the risk and he stated that the policy had been in force until 18 May 1912.

¹⁵⁹ [1922] 2 KB 461.

¹⁶⁰ [1922] 2 KB 461, 470.

¹⁶¹ [2001] 1 Lloyd’s Rep 378, 385; approved by Rix LJ, [2001] 2 Lloyd’s Rep 161, 183.

faith can be extended to the period after the contract has been concluded. If so, the second question is determining the proper remedy in the event of breach.

In the earlier authorities the continuing duty of utmost good faith was applied where the contract expressly required the assured to provide information material to the underwriter¹⁶². The remedy for breach of the duty was regarded as either avoidance of the policy *ab initio* or the discharging of the underwriter from liability for any claim tainted by lack of full disclosure¹⁶³. However in *K/S Merc-Scandia XXXXII v Lloyd's Underwriters (The Mercandian Continent)*¹⁶⁴ the Court of Appeal stated that although the proper remedy for breach of the duty of good faith was avoidance *ab initio*, that remedy was disproportionate to the post-contractual situation¹⁶⁵; instead, it was appropriate to invoke the remedy of avoidance in a post-contractual context only where the underwriter had the right to treat the entire contract as discharged by reason of the assured's repudiatory breach¹⁶⁶.

The point at issue here is that there is no specific mention of any continuing duty in the MIA 1906. It was decided by the majority of the Court of Appeal in *Container Transport International Inc v Oceanus Mutual Underwriting Association (Bermuda) Ltd*¹⁶⁷ that although ss.18 and 20 of the MIA 1906 dealt only with pre-contractual disclosure and misrepresentation, those sections were illustrations of the wider duty in s.17. It should also

¹⁶² *Black King Shipping Corporation v Massie (The Litsion Pride)* [1985] 1 Lloyd's Rep 437; *Continental Illinois National Bank of Chicago v Alliance Assurance Co. Ltd., (The Captain Panagos)* [1986] 2 Lloyd's Rep 470. Clarke *The Law of Insurance Contracts* para 27-1A1 commented that "The duty continues throughout the contractual relationship at a level appropriate to the moment".

¹⁶³ Another matter discussed regarding the continuing duty was fraudulent claims of the assured. For a detailed discussion see *Colinvaux & Merkin's Insurance Contract Law*, paras A-0707-A-0731; Foxton, "The post-contractual duties of good faith in marine insurance policies: the search for elusive principles" in *Marine Insurance : The Law in Transition*, 71.

¹⁶⁴ [2001] Lloyd's Rep IR 802.

¹⁶⁵ Under pre-contractual duty of utmost good faith, what should be voidable is the decision induced by the failure to disclose material facts and the agreement as to alteration of the original policy should not make the entire policy avoidable as there had been no breach of duty at the stage of formation of contract. See Bennett, *The Law of Marine Insurance*, para 4.196.

¹⁶⁶ At the time *The Mercandian Continent* was decided, Waller LJ in *Alfred McAlpine plc. v BAI (Run-off) Ltd* [2000] Lloyd's Rep IR 352 had suggested that the insurer had the right to treat the claim as repudiated, leaving the policy itself untouched. However, these comments were rejected by a majority of the Court of Appeal in *Friends Provident Life & Pensions Ltd v Sirius International Insurance Corp* [2005] 2 Lloyd's Rep 517, where the existence of the concept of repudiation of a claim was rejected for the reason that insurers were entitled to deny payment to the assured only where they were entitled to repudiate the policy as a whole, and there was no concept of partial repudiation in English law. See also *Ronson International Ltd v Patrick* [2006] Lloyd's Rep IR 194, aff'd [2007] Lloyd's Rep IR 85; Lowry and Rawlings "Innominate Terms in Insurance Contracts" [2006] LMCLQ 135, 139.

¹⁶⁷ [1984] 1 Lloyd's Rep 476.

be remembered that the House of Lords in *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd*¹⁶⁸ pointed out that the duty of utmost good faith was not based on any implied term and arose *ex contractu*. In *Phoenix General Insurance Co. of Greece S.A. v. Halvanon Insurance Co.Ltd.*¹⁶⁹ Hobhouse J declared that a continuing duty of utmost good faith could be implied into a proportional reinsurance contract, although his decision did not turn on that point and he ultimately decided that the reinsurers were protected by a series of implied terms. A narrower view of the continuing duty was adopted in *Bonner v Cox*¹⁷⁰ where Waller LJ in the Court of Appeal emphasised that good faith was purely a pre-contractual matter and that rights and obligations after placement were governed by the terms of the contract, and he implicitly doubted whether the implied terms suggested by Hobhouse J could be justified. It was also ruled in *Bonner* that neither a mere entitlement to cancel the policy by serving a notice of cancellation¹⁷¹, nor a mere increase of the risk, would create a continuing duty of utmost good faith¹⁷². The approach of Waller LJ now appears to represent the English law approach. In *Goshawk Dedicated Ltd v Tyser & Co Ltd*¹⁷³ Rix LJ held that the duty of utmost good faith was not free-standing but rather formed the basis for the implication of a term. In *Goshawk* the assured was held to be subject to an implied term to supply the insurers (through his broker) with placing and claims information which they had previously seen, and also premium information. The implied term was derived from the continuing duty of utmost good faith, but took effect contractually rather than on the free-standing basis that characterises the duty of utmost good faith.

More recently, in *HLB Kidsons v Lloyd's Underwriters*,¹⁷⁴ the duty has been discussed in relation to a notification of circumstances clause in a claims made liability policy. Toulson LJ accepted and Rix LJ agreed that under such circumstances “it is impliedly incumbent on the insured to see that any such notification is a fair, if summary, presentation of what the insured knows”. Both accepted that there might be an argument for a continuing duty of good faith in these circumstances. Toulson LJ felt that the appropriate remedy for a

¹⁶⁸ [1994] 3 All ER 581.

¹⁶⁹ [1985] 2 Lloyd's Rep 599.

¹⁷⁰ [2006] Lloyd's Rep IR 385.

¹⁷¹ *New Hampshire Insurance Co. v Mirror Group Newspapers Ltd.* [1997] LRLR 24.

¹⁷² *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd (The Star Sea)* [2001] 1 Lloyd's Rep 389.

¹⁷³ [2007] Lloyd's Rep IR 224.

¹⁷⁴ [2009] Lloyd's Rep IR 178.

breach of the duty was a holding that the notification is invalid; however, their Lordships did not express a firm view on the matter.

This rather complex debate aside, the continuing duty of utmost good faith seems to have almost no practical significance in the insurance context since it is difficult to think of a situation in which failure to comply with an information clause could be repudiatory¹⁷⁵. In the reinsurance context, irrespective of any clause requiring notification of increase of risk, the better view is that if risk has altered materially, the reinsurers would automatically be discharged from any further liability as a matter of law¹⁷⁶ and there is no need to consider breach of contract. However, as was said in *The Mercandian Continent*, breach of such a clause is a breach of contract and does not necessarily amount to a breach of the continuing duty of utmost good faith because obligations regarding the duty of disclosure after placement are governed by the terms of the contract.

It should be noted that the Australian Law Reform Commission's Report No 20¹⁷⁷ suggested that the post-contractual duty should be treated as an implied term of the contract of insurance, and that recommendation was implemented as s.13 of the Insurance Contracts Act 1984 (Cth)¹⁷⁸. Consequently, the remedy for breach of duty of utmost good faith is contractual. This gives rise to a much wider and more appropriate range of remedies than are currently available under the MIA 1906, including damages¹⁷⁹. However in the reinsurance context, the implied term proposal approach should be viewed in the light of the definition of reinsurance as "a business between consenting adults"¹⁸⁰, and it is most unlikely after *Bonner v Cox* that the courts would imply a term that the

¹⁷⁵ Merkin, *Marine Insurance Legislation*, 18-19; See also *Colinvaux & Merkin's Insurance Contract Law*, para A-724.

¹⁷⁶ *Swiss Re v United India Insurance* [2005] Lloyd's Rep IR 341.

¹⁷⁷ *Insurance contracts*, 1982. This report can be found at <http://www.austlii.edu.au/au/other/alrc/publications/reports/20/>. The same reform was suggested for the Marine Insurance Act 1909 (Cth) but it was not implemented. See ALRC 91 *Review of the Marine Insurance Act 1909* (2001). This report can be seen at <http://www.austlii.edu.au/au/other/alrc/publications/reports/91/>. See Derrington "Marine insurance law in Australia: the Australian Law Reform Commission proposals", LMCLQ 2002, 214-230.

¹⁷⁸ Section 13 provides that "A contract of insurance is a contract based on the utmost good faith and there is implied in such a contract a provision requiring each party to it to act towards the other party, in respect of any matter arising under or in relation to it, with the utmost good faith." A detailed legal and practical analysis on the Australian Law Reform was undertaken by Merkin on behalf of the English and Scottish Law Commissions. The report "Reforming Insurance Law: Is There A Case For Reverse Transportation?" where s.13 is discussed can be seen on http://www.lawcom.gov.uk/docs/merkin_report.pdf.

¹⁷⁹ Derrington, "Marine insurance law in Australia: the Australian Law Reform Commission proposals", 222; Soyer, "Continuing duty of utmost good faith in insurance contracts: still alive?" [2003] LMCLQ 39, 75.

¹⁸⁰ *Reinsurance Practice and The Law*, 1-1.

parties could have adopted themselves, and it is noteworthy that the 1984 Act does not apply to reinsurance¹⁸¹.

After the making of the contract, if the assured seeks to obtain additional cover and applies to the insurer for the appropriate extension by means of an endorsement, he is required to disclose material facts relating to the application and at this stage duty of disclosure will also be relevant¹⁸². It has been suggested that the preferable approach is that breach of such duty renders voidable only the extension itself and does not vitiate the entire policy¹⁸³. This is consistent with *The Mercandian Continent*, where Longmore LJ stated that only the extended cover and not the entire policy would be voidable even though the breach occurred during the currency of the policy. Accordingly, the endorsement would be avoided and the claim would be looked at according to the agreement that was before the endorsement. In reinsurance context, consistently with the principles mentioned above, a materially altered original policy would not be binding on the reinsurers but the reinsured's claim would be viewed according to the underlying policy terms before the alteration ie, in the form that the reinsured agreed to follow. The reinsurers would simply not be bound by the alteration because the altered original policy would not be the policy within the meaning of "as original".

3.4 Leading Underwriter Clause in the Original Policy

In the London Market it is often the case that in insurance contracts a follow the leader clause confers authority on the leading underwriter to agree certain matters on behalf of the following market. The clause may authorise the leading underwriter to alter the slip¹⁸⁴ and this raises the question whether the reinsurer is bound by the alteration of the original policy effected by the leading underwriter. This was the issue in *American International Marine Agency v Dandridge*¹⁸⁵ where the judge held that the leading underwriter clause in the direct policy could not be incorporated into the reinsurance agreement as this clause

¹⁸¹ 1984 Act, s.9(1)(a).

¹⁸² *Lishman v Northern Maritime Insurance Co* (1875) LR 10 CP 179; *Gaughan v Tony McDonagh & Co* [2006] Lloyd's Rep IR 230; *Colinvaux's Law of Insurance* para 6-106.

¹⁸³ *Fraser Shipping Ltd. v. Colton* [1997] 1 Lloyd's Rep 586; *Groupama Insurance Co Ltd v Overseas Partners Re Ltd* [2004] 1 CLC 779; *O'Kane v. Jones* [2004] 1 Lloyd's Rep 389; *Limit No. 2 Ltd v. Axa Versicherung AG* [2008] 2 CLC 673; *Colinvaux's Law of Insurance*, para 6-106; Bennett, para 6-106.

¹⁸⁴ *Barlee Marine Corp v Trevor Rex Mountain (The Leegas)* [1987] 1 Lloyd's Rep 471. The leading underwriter may also be authorised to agree the terms of the policy (*Unum Life Insurance Co of America v Israel Phoenix Assurance Co Ltd* [2002] Lloyd's Rep 374) or to waive conditions (*Roadworks v Charman* [1994] 2 Lloyd's Rep 99).

¹⁸⁵ [2005] Lloyd's Rep IR 643.

did not meet any of the four criteria set out in *HIH v New Hampshire*. According to Mr Siberry QC, a leading underwriter clause was not germane to reinsurance because such a clause concerned the relationship between the leading underwriter and the following market, as well as that between the following market and the assured. There was no mutuality of interest between the leading underwriter and the reinsurers. For instance, reduction in insured value agreed by the leading underwriter where the policy covered total loss only might be very prejudicial to the reinsurers' interest. The claimant did not argue that the clause was incorporated in its manipulated form and the trial judge commented that this clause did not make sense in the context of the reinsurance in its unmanipulated form since Axa, the leading direct underwriter, was not the leading underwriter of the reinsurers. Furthermore Mr Siberry QC found the clause to be inconsistent with the other terms of the reinsurance, because Axa reduced the value of the subject matter insured although its value was agreed at a higher figure in the reinsurance contract. He referred to *Norwich Union v Colonial Mutual* and held that the leading underwriter clause would bind the reinsurer to the valued policy amended from time to time.

Unfortunately although the reinsured argued that the clause was incorporated in unmanipulated form with the same effect as that set out in *HIH v New Hampshire*, the judge rejected the argument for the reasons, inter alia, that the clause in *HIH* directly regulated the relationship between the insurer and the assured. To a certain extent Mr Siberry QC's concerns are explicable but his reasons are unconvincing¹⁸⁶. The distinction between the fact of incorporation and the effect of incorporation could have been recognised for the incorporation of the follow the leader clause as well. As a matter of fact, the result achieved in *HIH* was that the function of incorporation could be described as merely recognition of the effect of the clause in the direct policy, and operates as no more than a follow the settlements provision. The effect of the follow the leader clause would be that the reinsured would be bound by alteration agreed to by the leading underwriter and consequently the reinsurer would be forced to accept the amended terms that the reinsured had secured according to the alterations of the policy. If the effect of incorporation was adopted as it had been in the *HIH* case, neither of the reasons of the trial judge would have been applicable to the case.

¹⁸⁶ Butler and Merkin, para B-0149/2.

3.5 Obligations of the Assured under the Direct Policy

It has not yet been settled whether the “as original” wording imposes upon the reinsured any duty corresponding to that to which the assured is subject under the original policy. All depends upon the nature of the obligation and the applicability or appropriateness of the clause at the level of reinsurance. For instance, in *Sulphite Pulp Co Ltd v Faber*¹⁸⁷ the same premises had been insured by various leading fire insurance companies including NBMC. Clause 6(d) of its policy provided: “So long as this insurance remains in force the insured shall notify to the company and have specified in the policy if some other insurance is taken out, or any insurance previously effected ceases”. Later on the assured took out a second fire policy from a Lloyd’s Underwriter which was “subject to the same terms and conditions as a policy or policies of the [NBMC] ... on identical interest, and in the case of loss it is hereby agreed to settle hereon according to the adjustment adopted by the said company or companies.” Failure to adhere to this clause was to render the policy void. The property insured was destroyed by fire but before the fire occurred, renewal of all of the earlier policies was declined, but this fact was not disclosed to the Lloyd’s underwriter, who sought to determine the second policy for breach of cl 6(d) in the earlier policy. Lord Russell of Killowen CJ held that the clause requiring the assured to notify the insurer if any insurance previously taken out ceased to operate was not inconsistent with the terms of the reinsurance agreement and the obligation was equally applicable to the assured of the later effected insurance policy. Consequently the Lloyd’s policy was held to have incorporated the terms and conditions of the NBMC policy, including cl 6(d), so that the Lloyd’s underwriter was entitled to regard the assured in breach of that condition.

Similarly, in *Home Insurance Co of New York v Victoria Montreal Fire Insurance Co*¹⁸⁸ the question was the applicability to the retrocession agreement of a time bar clause in the original policy. The assured made a claim in the twelve-month period allowed by the original policy but, because of lengthy negotiations with the reinsured, the reinsurers could not submit their claim against the retrocessionaire before the twelve-month period had expired. The Privy Council considered the applicability of the time bar clause to the retrocession agreement and took account of the fact that a time bar clause made sense in an insurance contract as the assured is the master of the situation, but the reinsurer could not move until the direct loss had been ascertained between the assured and the reinsured.

¹⁸⁷ (1895-96) 1 Com Cas 146.

¹⁸⁸ [1907] AC 59.

According to their Lordships this rendered the clause inappropriate to the contract between the reinsurer and the retrocessionaire¹⁸⁹. Moreover, in *Municipal Mutual Insurance Ltd v. Sea Insurance Co Ltd*¹⁹⁰ the term requiring the assured to ask written consent of the insurer prior to incurring legal costs was found to be inappropriate to the reinsurance contract.

Nevertheless, the court may be keen on giving some purpose to incorporation if the reinsurance is not on the same terms as original but incorporates the same standard wording as original¹⁹¹.

3.6 Other forms of Incorporation Wording

The full reinsurance clause may be qualified to overcome the requirements of incorporation set out in *HIH v New Hampshire*. For instance, in *Property Insurance Company Ltd v National Protector Insurance Company Ltd*¹⁹² the retrocession contract was “subject without notice to the same clauses and conditions...”. Scrutton J interpreted the phrase “without notice” as a declaration by the retrocessionaire that he would accept the terms of the original policy without notice of what the clauses and conditions were, to the effect that the retrocessionaire waived his right to claim to be informed about the unusual clauses in the policy¹⁹³. This case confirms the importance of the nature of the clause that is to be incorporated. As indicated above, in some cases the reasons for accepting incorporation are based on the usual nature of the clause. It can be said that the expression “without notice” can override the obstacle caused by its unusual character. In other words, while in the ordinary case, successful incorporation of an unusual clause is subject to the reinsurer being informed of the existence of that clause, the words “subject

¹⁸⁹ In *Home Insurance* the full reinsurance clause was not the issue, but the reinsurance and retrocession were effected by attaching to a printed form of fire insurance policy a typewritten slip or rider containing the special terms of the so-called reinsurance. The printed form was not amended except by the insertion of the syllable “re” before the word “insure” thus substituting the expression “does re-insure” for “does insure”. Lord Macnaghten interpreted this as incorporation of the original insurance into the reinsurance contract but he distinguished some provisions that could not be applicable to the reinsurance.

¹⁹⁰ [1996] CLC 1515, 1527. Cf *Friends Provident Life & Pensions Ltd v Sirius International Insurance Corp* where the Court of Appeal accepted the incorporation of notice provision into the excess insurance from the primary insurance.

¹⁹¹ *Axa v Ace Global Markets* [2006] Lloyd’s Rep IR 683; *CNA International Reinsurance Co Ltd & Ors v Companhia de Seguros Tranquilidade SA*.

¹⁹² (1913) Com Cas 119.

¹⁹³ He also pointed out that the clause was in written form and not printed. This also convinced him as to the parties’ intentions regarding the function of the words “without notice”.

without notice the same terms and conditions” overcome the problem and permit incorporation whatever the nature of the clause.

CHAPTER 4 PRESUMPTION OF BACK-TO-BACK COVER

4.1 The General Principle

4.1.1 Scope of the Principle

In facultative reinsurance contracts, since the reinsurer takes over a proportion or all of the risk that the direct insurer has insured, it is presumed that in the absence of clear words to the contrary the risks covered by the two contracts are consistent¹⁹⁴. In line with the theory that the subject matter of reinsurance is liability of the direct insurer undertaken by his original contract of insurance, the back-to-back presumption can be construed to mean that when the insurer's liability is established under the original policy the reinsurer will accept liability to pay whatever percentage of the claim he has agreed to reinsure¹⁹⁵. This makes it clear that the presumption ensures that the two contractual terms are identical without any need to carry the original insurance terms into the reinsurance. Nevertheless, it has been held that the incorporating wording amounts to an indication of the parties as to the intention of back-to-back cover¹⁹⁶. In conformity with this supposition, in most cases the presumption of back-to-back cover has been given a function which operates in conjunction with the incorporation wording. As will be seen below, this approach has caused not only artificial distinctions to be drawn but also sometimes has involved disregarding the express terms of the reinsurance agreement.

4.1.2 Rebutting the Presumption

The presumption of back to back cover is relevant only where the parties are to be taken to have intended that outcome. If identical words are used in the two contracts then the presumption will operate, even though the two contracts are governed by different

¹⁹⁴ *American International Marine Agency of New York Inc v Dandridge* [2005] Lloyd's Rep IR 643; *Toomey v Banco Vitalicio De Espana SA de Seguros* [2004] Lloyd's Rep IR 354; *HIH Casualty and General Insurance Ltd v New Hampshire Insurance Co* [2001] 2 Lloyd's Rep 161; *Mann v Lexington Insurance Co* [2001] Lloyd's Rep IR 179; *Reliance Marine Insurance v Duder* [1913] 1 KB 265; *Citadel Insurance Co v Atlantic Union Insurance Co SA* [1982] 2 Lloyd's Rep 543. The presumption may be inapposite if the risk as presented to reinsurers differs materially from the risk as assumed by the reinsured: *Gan Insurance v Tai Ping Insurance (No.1)* [1999] Lloyd's Rep IR 472. Cover is not presumed to be back-to-back in non-proportional reinsurance contracts: *AXA Reinsurance (U.K.) Plc. v Field* [1996] 2 Lloyd's Rep 233; *American Centennial Insurance Company v Insko Limited* [1996] LRLR 407; *Municipal Mutual Ins Ltd v Sea Ins Co Ltd* [1996] CLC 1515; *Goshawk Syndicate Management Ltd v XL Speciality Insurance Co.* [2004] Lloyd's Rep IR 683. The existence of such a presumption was doubted and of a very small compass if it exists at all: Weir, 214.

¹⁹⁵ Lord Griffiths in *Forsikringsaktieselskapet Vesta v Butcher* [1989] 1 Lloyd's Rep 331, 336.

¹⁹⁶ Rix LJ in *HIH v New Hampshire* [2001] 2 Lloyd's Rep 161, para 169; *Goshawk v XL Speciality Insurance*; O'Neill and Woloniecki, para 4-02.

applicable laws¹⁹⁷. The same conclusion follows if the words are not identical but virtually indistinguishable¹⁹⁸. However, if the words used are quite different, and deliberately so, then the presumption may be rebutted. In *Youell v Bland Welch & Co.Ltd*¹⁹⁹ Beldam LJ did not allow the presumption to be used to modify the meaning of a reinsurance term. In this case, the claimant insurers issued policies against builder's risks and other associated risks of three liquefied gas carrying vessels while under construction in the US. The reinsurance policy however contained a clause that limited the scope of reinsurance namely that "The reinsured shall cede to the reinsurers and the reinsurers shall accept by way of reinsurance of the reinsured their proportion of the reinsured's liability in respect of risks attaching for periods as original (up to but not exceeding 48 months) . . . in respect of vessels . . . whilst under construction . . . and until handed over to and accepted by . . . owners." When the vessels became constructive total losses as a result of perils insured against, 48 months had expired after each vessel had come on risk but the original cover was still in force. The reinsureds alleged that the reinsurance cover was still in force because the reinsurance policy should be so construed that the cover provided was co-extensive with the cover contained in the primary policies. Beldam LJ noted that the presumption of back-to-back cover was inapplicable to this case as the reinsurers accepted the risk on special terms²⁰⁰.

Moreover, in *Aegis Electrical and Gas International Services Co Ltd v Continental Casualty Co*²⁰¹ the original insurance and reinsurance policies contained different definitions of "accident". Original policy Clause 30 defined an accident as meaning "a sudden and accidental breakdown of an object or a part thereof and resulting in physical damage that necessitates repair or replacement of the object or part thereof". Additional clauses attached to the reinsurance policy defined accident as "a sudden and accidental breakdown of an Object or a part thereof, which manifests itself at the time of the occurrence by physical damage that necessitates repair or replacement of the Object or part thereof", but excluding loss or damage resulting "from explosion other than explosion

¹⁹⁷ See 4.2 below.

¹⁹⁸ As in *Wasa International Insurance Co Ltd v Lexington Insurance Co.* [2008] 1 CLC 340.

¹⁹⁹ [1992] 2 Lloyd's Rep 127.

²⁰⁰ [1992] 2 Lloyd's Rep 127, 138-139. See also *Abrahams v Mediterranean Insurance and Reinsurance Co Ltd* [1991] 1 Lloyd's Rep 216 where the Court of Appeal held that the term "subject to original conditions but against total and/or constructive total loss" did not create "all risks" cover. It was held that because the contract was an open cover, all hull covers could be ceded whatever their terms but if such terms were wider than total loss then only the total loss element was ceded.

²⁰¹ [2008] Lloyd's Rep IR 17.

of the parts of steam boilers, steam turbines, steam engines, steam pipes interconnecting any of the foregoing or gas turbines”. The reinsurance also provided “To follow the terms, clauses, conditions, exceptions and settlements of the original policy wording as far as applicable hereto”. The reinsured argued that the follow the terms provision in the reinsurance slip favoured a match between the terms of the insurance slip and the reinsurance slip, and therefore any mismatch between them should be minimised. It was also argued that any ambiguity was to be resolved contra proferentem against the reinsurers both because they proposed the additional conditions for inclusion in the contract and because they sought to rely upon the exception in the “Additional Conditions”. Andrew Smith J emphasised that every case depends upon the proper construction of the particular reinsurance contract. He held that the reinsurance contract in this case was not back to back because the reinsurers reinsured only some of the risks that fell within the original cover and in that sense the insurance cover and the reinsurance cover were not back to back. Andrew Smith J described the Additional Clauses as modifying the extent of the reinsurance cover; he found no ambiguity in the effect of those Additional Clauses²⁰².

It should be noted that in *Wasa v Lexington* even though the reinsurance and original insurance terms were more or less identical²⁰³ and the question was stated to be whether those terms should be construed the same way, the Court of Appeal did not ground their decision on the presumption of back-to-back cover. Longmore LJ found that the presumption was not helpful, because the reinsured argued that the contracts were back-to-back so the interpretation of the original policy was binding on the reinsurers, whereas the reinsurers asserted that the contracts were not back-to-back therefore the contracts fell to be construed differently, ie according to the different laws applicable to them. Longmore LJ (Pill and Sedley LJ agreeing) noted that any distinction between coverage and warranties (the issue in *Vesta v Butcher*, discussed below) was one of fact rather than principle²⁰⁴, as both warranties and coverage clauses had much the same effect and thus were to be treated in the same way. Accordingly, the construction of the reinsurance had to match that of the direct policy.

²⁰² In *Aegis* the two contracts were held not to be back-to-back, by reason of the clearly different wording used in the insurance and in the reinsurance, by way of contrast to the position in *Insurance Co of Africa v Scor (UK) Reinsurance Co Ltd* [1985] 1 Lloyd’s Rep 312.

²⁰³ Three years in the insurance contract; 36 months in the reinsurance agreement.

²⁰⁴ [2008] 1 CLC 340, 357.

4.2 The Relationship between the Presumption and Incorporation

4.2.1 *Forsikringsaktieselskapet Vesta v. Butcher*

In this –leading – authority, incorporation wording was given effect by virtue of the presumption of back-to-back cover. A Norwegian insurance company, Vesta, insured a fish farm against inter alia loss of living fish from any cause whatsoever. The original insurance policy contained a 24-hour watch warranty and the reinsurance policy was on the same terms and conditions as original. The reinsurance policy was effected by virtue of a standing offer and when the assured saw the warranty in the wordings of the insurance, he informed the brokers that he could not comply with it; however the brokers did not pass the information to the reinsurers. The fish farm was seriously damaged by a violent storm and even if the 24-hour watch warranty had been adhered to, the damage could not have been prevented. Under Norwegian law, breach of warranty provides a defence to the underwriters only if the breach was causative of the loss. Consequently, Vesta settled the claim but the reinsurer refused reimbursement on the ground that the reinsurance contract was governed by English law and the breach of warranty relieved them from liability even if there was no causal link between the loss and the breach. At first instance, Hobhouse J held that the parties' intention was that the warranty in the reinsurance contract was to be governed by Norwegian law as the reinsurance policy incorporated the terms of the original insurance²⁰⁵. More interestingly, he noted that if he had not concluded that, he would have held that both contracts were governed by Norwegian law. Nevertheless his latter comment was described as "quite unrealistic" by the Court of Appeal and it was concluded that two contracts were clearly governed by different laws²⁰⁶. Finally, the House of Lords held that in the absence of any express declaration to the contrary in the reinsurance policy, the contracts were to be construed back-to-back; as a result, the incorporated warranty in the reinsurance contract was to be given the same effect as in the direct policy with the consequence that a breach of warranty which was not causative did not discharge the reinsurers from liability²⁰⁷. It was common ground throughout the proceedings that the Norwegian warranty had been incorporated into the reinsurance, and the case proceeded on that basis: only Lord Griffiths in the House of Lords raised any doubt as to the correctness of the concession.

²⁰⁵ [1986] 2 All ER 488.

²⁰⁶ [1988] 2 All ER 43.

²⁰⁷ [1989] 1 Lloyd's Rep 331.

4.2.2 *Groupama Navigation et Transports & Ors v. Catatumbo Seguros*

The *Vesta* decision has nothing to say about the effect of an express warranty in the reinsurance contract, although this may be considered as an indication contrary to the presumption of back-to-back cover, and the express warranty in the reinsurance agreement might be thought to be one which is to be given effect according to the law which governed that contract. Nevertheless, the Court of Appeal in *Groupama*²⁰⁸ confounded this analysis by deciding that even though there was an express warranty in the reinsurance contract, because of the assumption that the reinsurance cover was identical to the direct insurance, the reinsurance cover was to be construed so as to produce the same effect as the underlying warranty. In *Groupama* a fleet of vessels was insured against hull and machinery losses. The original policy provided for a warranty, “Guarantee of maintenance of class. . .”. The reinsurance contract contained the clause “All terms clauses conditions warranties. . .as original and to follow all decisions settlements agreements of same in every respect. . .Warranted existing class maintained.” Two vessels were heavily damaged in a storm and after subsequent investigation it became apparent that the vessels had not been classed during the currency of the policy. The reinsured was liable despite the breach of warranty because, in much the same way as in *Vesta*, the underlying contract was governed by a foreign law – that of Venezuela – which requires a causal link between the breach of warranty and the loss in order to discharge the insurer from liability. The reinsurers nevertheless argued that the reinsurance warranty was “free standing” and to be construed as discharging them from liability without regard to the construction of the original policy warranty, given that the contract was governed by English law. David Steel J and the Court of Appeal placed emphasis on the proportional nature of the reinsurance policy and the presumption of back-to-back cover. The Court of Appeal ultimately held that the presumption governed the case, because the terms of the original insurance were incorporated by virtue of the “as original” clause. As a consequence of incorporation the Court of Appeal stated that there were two warranties in the reinsurance contract: one was incorporated from the direct policy; and the other was expressly set out in the reinsurance agreement itself. The two warranties were identical except for the fact that the classification society was named in the insurance. Tuckey LJ stated that if the parties intended the two warranties to be construed differently in the two contracts they should have said so. The Court was of the opinion that the reinsurers were assumed to have

²⁰⁸ [2000] 2 Lloyd’s Rep 350.

accepted the risk of such interpretation by writing international business²⁰⁹. Mance LJ emphasised that had the two contracts contained warranties expressed in different and irreconcilable terms, or if the reinsurance had contained a warranty which had no counterpart in the insurance, different considerations could have arisen as it would then be clear that the two contracts were not and could not to that extent be treated as back-to-back²¹⁰. Consequently neither the difference between the applicable laws, nor express warranties of the reinsurance policy was enough to rebut the presumption of back-to-back cover.

4.2.3 Implications of the Relationship between Back-to-Back Cover and Incorporation

As a result of the *Groupama* decision, it is now arguable that the courts may allow incorporation of inconsistent terms which override an express but parallel term of the reinsurance contract. In *Groupama* the facts were obviously different from *Vesta* as in the latter there was no express reinsurance warranty. However the *Vesta* case was not distinguished and no consideration has been given to the parties' intention in putting an express warranty in the reinsurance policy. Instead, David Steel J stated that separate warranties did not produce any conflict at worst they were mere surplusage²¹¹. On the other hand Tuckey LJ expressed his view that although it made it repetitive, having warranties in the reinsurance policy must have a purpose and this purpose was to provide identical interpretation with the original insurance²¹². Mance LJ also commented that the reinsurance warranty could be regarded as provisional, designed to be effective only if there was no such warranty in the direct cover. More doubtfully, it was also stated that the reinsurance warranties were not "free standing"; their intention was no more than specifying terms which the reinsurers would have expected to be in the direct policy. Clearly this explanation is not consistent with the requirements of incorporation, as incorporation of the original insurance provisions is permitted only if incorporation does not create any inconsistency²¹³. Obviously, in both *Groupama* and *Vesta*, warranties, breach of which requires causative links with the loss, were inappropriate to the

²⁰⁹ [2000] 2 Lloyd's Rep 350, 354.

²¹⁰ [2000] 2 Lloyd's Rep 350, 356.

²¹¹ [2000] 1 Lloyd's Rep 266, 268.

²¹² [2000] 2 Lloyd's Rep 350, 354.

²¹³ *Home Insurance Company of New York v Victoria – Montreal Fire Insurance Company* [1907] AC 59; *Pine Top Insurance Co. Ltd. v Unione Italiana Anglo Saxon Reinsurance Co. Ltd* [1987] 1 Lloyd's Rep 476. See also *Municipal Mutual v Sea Ins* where the reinsurance stated "conditions as underlying" but it was found to be wrong in principle to apply the presumption so as to distort or disregard the terms of the reinsurance contracts in order to make them match the direct policy.

reinsurance policies which were governed by English law²¹⁴. As a result of the Court of Appeal's judgment it has become possible to say that an incorporated term can override an express term of the reinsurance contract, but perhaps only where there is something equivalent to the reinsurance provision in the direct policy. Although there are authorities indicating that the express terms of the reinsurance dealing with premiums could not be overridden by any incorporated provision²¹⁵, *Groupama* remains good law. On the other hand the principle stated in *Groupama* seems to be inapplicable to the cases where the insurance and reinsurance contracts contain warranties in different and irreconcilable terms. Moreover *GE Reinsurance Corporation v New Hampshire Insurance Co*²¹⁶ makes it clear that an express warranty in the reinsurance policy can be assessed independently where the original policy does not contain any equivalent clause. Langley J held that neither the presumption of back-to-back cover nor the incorporation wording could be used to oust an express provision in the reinsurance contract if there was no clause in the original policy which regulated the same issue²¹⁷.

4.2.4 Independent Operation of the Presumption

The presumption of back-to-back cover is simply a rule of construction²¹⁸ and if both *Vesta* and *Groupama* had been decided by taking into consideration only the back-to-back nature of the contracts, the same results could have been achieved with less complicated reasons. For example in *Vesta*, the reinsurer took over 90% of the liability of the reinsured under the original contract of insurance. There was no contrary indication in the reinsurance contract; therefore it could be presumed that the insurance and reinsurance were back-to-back. Hence because the original insurer was liable under Norwegian law, the reinsurer should have been required to reimburse the reinsured regardless of the different laws applicable to those two contracts. Nevertheless adopting the view that the "as original" clause incorporated the direct policy terms into the reinsurance contract led

²¹⁴ In *Groupama* at first instance David Steel J accepted that express warranties in the reinsurance policy precluded incorporation, but the Court of Appeal disagreed. Moreover in *Vesta*, referring to *Home Insurance*, Lord Griffiths came close to accepting that a warranty appropriate to the insurance policy but inappropriate to the reinsurance policy could not be incorporated, but he based his decision on the principle that the reinsurance and the insurance contracts were back-to-back and the warranty was to have the same effect in both.

²¹⁵ *Heath Lambert Ltd v Sociedad de Corretaje de Seguros* [2004] Lloyd's Rep IR 905.

²¹⁶ [2004] Lloyd's Rep IR 404.

²¹⁷ It was also pointed out that there was no implied term in a reinsurance agreement that the reinsurers would not rely upon a defence not available to the reinsured. See also *Dornoch Ltd v Mauritius Union Assurance Co Ltd* [2006] Lloyd's Rep IR 786.

²¹⁸ *GE Reinsurance Corp v New Hampshire Insurance*. In *American International Marine Agency v Dandridge* [2005] Lloyd's Rep IR 643 para 40, it was said that the incorporation issue was dependent on the parties intentions objectively ascertained from the surrounding circumstances.

the House of Lords into long and complicated discussion. Similarly, the incorporation point made the reasoning in *Groupama* more difficult, because the Court of Appeal first had to decide if the incorporated warranty was in conflict with the reinsurance warranty, and then it discussed the construction of the incorporated warranty in the reinsurance contract. If incorporation had been ignored and instead the terms of the two contracts had been compared, it could have been seen that the parties did not intend that the reinsurers should have any greater rights than the reinsured, so that the back to back cover presumption would have allowed the reinsured to succeed. Moreover because it is the case that in proportional contracts the reinsurers are in principle liable where the reinsured's liability is established and quantified, again the same result could have been achieved with a more simple approach than that actually adopted. Consequently there would have been no difficulty from the conclusion that the contracts were governed by different laws and, furthermore, it would have been unnecessary to decide whether the terms of the insurance policy meant the same in Norwegian/Venezuelan and English law²¹⁹.

The abovementioned analysis makes it clear that in fact incorporation adds nothing to the presumption of back-to-back cover as regards insuring clauses²²⁰. These two cases aside, many other attestations can be shown to strengthen the view that the presumption is sufficient on its own to solve the disputes. For instance in *Marten v Steamship*²²¹ the dispute was simply resolved by applying the principle that the terms of reinsurance and insurance were identical. Even though the reinsurance contract contained no words of incorporation Bigham J found no impediment to holding that the object of the reinsurance policy was to indemnify the reinsured against the risk of total loss covered by the policy which they themselves had issued²²². Furthermore it has been decided that the presumption of back-to-back cover does not extend to ancillary terms such as claims control, law and jurisdiction and arbitration clauses²²³. Consequently it appears that even if there are no incorporating restrictions, the presumption on its own has the same function as that created by the incorporation rules. Accordingly, whether or not the two contracts are back-to-back can be left to be determined by the wording of the agreements themselves and there is no need for incorporation.

²¹⁹ Merkin "Reinsurance, Brokers and The Conflict of Laws", [1988] LMCLQ 5, 9.

²²⁰ Merkin, "Incorporation of Terms", 99.

²²¹ (1902) Com Cas 195.

²²² Cf *General Insurance Co of Trieste Ltd v Corporation of the Royal Exchange* (1897) 2 Com Cas 144 where Mathew J accepted that the clause had been incorporated from the reinsurance into the retrocession contract but could have reached the same result by simply applying the presumption.

²²³ Per Tuckey LJ in *Groupama* at 354.

It should also be noted that Lord Griffiths in *Vesta* called for urgent consideration of the redrafting of the London Market standard forms of reinsurance policy²²⁴. However redrafting is not the only way of preventing the problems that the incorporation theory has so far created. The solution could be accomplished plainly by recognising that the “as original” wording only affirms that the terms of insurance and reinsurance are identical and that incorporation does not add anything to the presumption which can operate independently of incorporation, as can be clearly seen in *Wasa v Lexington*.

4.2.5 Incorporation in Facultative Non-Proportional Reinsurance

Although it is less commonly the case, facultative reinsurance agreements can be non-proportional, as where the reinsurer reinsures a layer of the liability of the insurer on a single risk²²⁵. The question whether incorporation is inevitable in such contracts that have been worded “as original” has not yet been tested.

The main arguments, when rejecting the operation of the presumption in non-proportional agreements, were that, in contrast to proportional transactions, the parties cannot be classified as co-adventurers since reinsurers assess the merits of writing particular business on different criteria, depending on where they fitted into the insurance chain²²⁶. A direct insurer may issue various policies under which he can fix the deductible and limit of liability according to his knowledge of the policy holders and of the likely size and incidence of the insured risks. On the other hand an underwriter who takes a line on a layer of an excess of loss contract must take a much broader view, as he cannot rate the individual policy holders and individual risks directly. Therefore if the parties intend to give the same effect to their respective contracts, they could write them in the same terms. Accordingly, it becomes arguable that, because the presumption does not operate in non-proportional facultative contracts, general words of incorporation have the significant function of incorporating the provisions of the original insurance into the reinsurance agreement.

²²⁴ [1989] 1 Lloyd’s Rep 331, 338.

²²⁵ For instance if the reinsurer reinsures 100% of the reinsured’s liability in excess of £200,000 up to £400,000, if the loss is £100,000 the reinsurer pays nothing whereas if the loss is £400,000 the reinsurer pays £200,000.

²²⁶ *AXA v Field*; *American Centennial Insurance Company v Insko*; *Municipal Mutual Ins Ltd v Sea Ins Co Ltd*.

It should nevertheless be borne in mind that there may be cases in which the presumption can operate although the contract is not proportional. For example in *Goshawk v XL Speciality Insurance* an excess of loss reinsurance was worded “All as per original”. Morison J took into consideration that the reinsurer charged two-thirds of the premium set by the reinsured for the insurance, and held that the cover should match the underlying insurance as far as possible although it was not a classic fronting arrangement. This approach could be open to doubt if this assumption has no factual basis²²⁷. However it appears that the answer much depends on the overall intention of the parties to be back to back based on the terms and incorporation.

²²⁷ Merkin, “Reinsurance”, *Ins LM*, November 2004, 11.

PART B FOLLOW THE SETTLEMENTS

As it was stated in the previous part of this thesis, facultative reinsurance contracts subscribed in the London Market usually consist of a cover page that typically provides only the full reinsurance²²⁸ clause by which the reinsurer undertakes to follow the settlements of the reinsured. The clause is widely used and has an important application in reinsurance practice. It has been a long process for the Market to establish the practice of the follow the settlements clause, but there remain further issues to explore. In this part of the thesis the historical development of the clause will be examined, followed by various issues that the English usage of the clause has established to date.

CHAPTER 5 REQUIREMENTS TO MAKE PAYMENT AGAINST THE REINSURER

5.1 In the Absence of Follow the Settlements Clause

The principle of indemnity is said to be an essential part of reinsurance contracts²²⁹. Accordingly, as held in *Re London County Commercial Reinsurance Office Ltd.*²³⁰ a reinsured who wishes to make a claim against the reinsurer must prove his loss in the same manner as the original assured must have proved it against him, and even if the reinsured did not rely on them, the reinsurers can raise all defences which were open to the reinsured against the original assured. Lord Mustill has recently emphasised the same principle, by holding that the loss must fall both within the scope of the original insurance and the reinsurance contract²³¹. Consequently, it is now an established principle that the reinsurer is not obliged to indemnify the reinsured if the reinsured chose to make payment to the assured where in fact the original policy did not cover the loss in question²³².

²²⁸ Leaving aside premium, duration and claims provisions.

²²⁹ Golding, 11.

²³⁰ [1922] 2 Ch 67, 80, PO Lawrence J.

²³¹ *Hill v Mercantile & General Reinsurance Co Plc* [1996] 3 All ER 865.

²³² [1922] 2 Ch 67, 80 PO Lawrence J.

5.2 Establishing and Quantifying the Reinsured's Liability under the Direct Policy

The reinsured can establish its liability to the assured by judgment, arbitration award or settlement²³³.

5.2.1 Judgment

The reinsured's liability is accepted to have been automatically proved where it is established by a judgment in favour of the assured²³⁴. However it is often the case that the reinsured and the reinsurer are not in the same jurisdiction. Therefore the reinsured may make its claim against the reinsurer by relying on a judgment given by a competent court in its own jurisdiction which is not that of the reinsurer. In that case it may be argued that the judgment is not binding on the reinsurer as the reinsurer was not a party to the dispute. Nevertheless, it is accepted that there is an implied term that unless the contract contains any provisions to contrary effect, the reinsurer accepts to be bound by a foreign court judgment in terms of establishing the reinsured's liability to the assured²³⁵. This principle is subject to four requirements set out by Potter LJ in *Commercial Union v. NRG*:

- (1) The foreign Court is of competent jurisdiction in the eyes of the English Court,
- (2) That judgment has not been obtained in the foreign Court in breach of an exclusive jurisdiction clause or other clause by which the original insured was contractually excluded from proceeding in that Court (eg, an arbitration clause),
- (3) The reinsured took all proper defences,
- (4) The judgment is not manifestly perverse.

It seems that while the first three conditions are consistent with the general principles of law, the operation of the last requirement is questionable. The meaning of perverse is not clear. In the *Commercial Union* case Potter LJ did not find it necessary to clarify the situation in which a plea of perversity might successfully be raised in respect of the decision of a foreign court, because on the facts before him the point did not arise²³⁶.

²³³ *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd (No.2 & 3)* [2001] 1 Lloyd's RepIR 667, 691.

²³⁴ *Lumbermans Mutual Casualty Co v Bovis Lend Lease Ltd* [2005] 1 Lloyd's Rep 494.

²³⁵ *Commercial Union Assurance Co. Plc. v. NRG Victory Reinsurance Ltd.* [1998] 2 Lloyd's Rep 600; see Dicey, Morris and Collins, para 14-033.

²³⁶ [1998] 2 Lloyd's Rep 600, 611.

If “perverse” means very wrong, determination of a decision as perverse would require the English court to analyse the facts and the issues in the proceedings brought by the reinsured against the reinsurer. However this would mean making another decision on the same issue, an approach which is contrary to the usual rule that judgments of foreign courts must be recognised and enforced in England without regard to their substance²³⁷. In principle a foreign judgment cannot be challenged in the English courts, so that findings of fact must be accepted and errors of law must be ignored²³⁸. In terms of enforcing of a foreign court decision, there are limited objections available, eg, that the judgment has been obtained by fraud or its enforcement or recognition would be contrary to public policy²³⁹. There is little authority on the meaning of public policy in this context and it has yet to be determined in England whether the enforcement of a foreign judgment which is for exemplary, punitive, or manifestly excessive damages should be refused on grounds of public policy²⁴⁰. However it should be noted that the binding effect of a judgment on reinsurers is a quite separate question to whether a foreign judgment is enforceable in England. If the assured has been awarded punitive damages in the US against an insurer, the English courts may refuse to enforce that award on public policy grounds. However the question in reinsurance is not public enforcement, it is whether as a matter of contract reinsurers have agreed to be bound by a punitive damages award, and in practice they will not. Consequently, although the meaning of perverse is not clear, and it may be explained as very wrong, an English court would almost certainly refuse to make a determination on the correctness or otherwise of a foreign decision as to its substance. Therefore the requirement of not being manifestly perverse does not seem to be very useful or in practice, applicable.

It has been suggested that the implication of a term in reinsurance contracts to the effect that the reinsurer is assumed to have agreed to be bound by a foreign judgment with regard to the proof of the reinsured’s liability is inappropriate²⁴¹. This opinion seems to suggest

²³⁷ This is a common law principle, but is now established by various international agreements incorporated into English law, most importantly the Brussels Regulation and the Lugano Convention as regards European Judgments. There are only limited defences that can be raised in proceedings to enforce a foreign judgment in England. See *Colinvaux & Merkin’s Insurance Contract Law* para D-0866; *Dicey, Morris and Collins on The Conflict of Laws*, Chapter 14.

²³⁸ The principle arises from the old case *Goddard v Gray* (1878) LR 6 QB 39. See also *Dicey, Morris and Collins*, para 14-110; *Colinvaux and Merkin’s Insurance Contract Law*, para D-0866.

²³⁹ See *Dicey, Morris and Collins*, Chapter 14; *Colinvaux and Merkin’s Insurance Contract Law*, para D-0866 – D-0872.

²⁴⁰ *Dicey, Morris and Collins*, para 14-146.

²⁴¹ O’Neill and Woloniecki, para 5-29.

that such a term could only be implied where there is a follow the settlements clause, and where the parties have chosen not to insert the clause in a reinsurance contract; this would also indicate that they have expressed an intention contrary to the effect of the implied term. Moreover it is claimed that implying such a term would bind the reinsurers to a judgment when they had not been involved in the proceedings. Besides that, implication would be inconsistent with the approach adopted by the Court of Appeal in *Insurance Co of Africa v Scor (UK) Reinsurance Co Ltd*²⁴² that in the absence of a “follow the settlements” clause the reinsured would not have been bound by the Liberian Court’s decision as to the coverage of the original policy. Therefore it is suggested that the better view would be the decision of a foreign court should be taken as no more than evidence of liability that to be determined by the court which will also decide on the reinsurer’s liability towards the reinsured²⁴³.

However counter arguments can be brought against this suggestion. Where a reinsurance contract contains a follow the settlements clause the reinsurer will be bound by the reinsured’s bona fide and businesslike settlement even though the reinsurer was not involved in the settlement process²⁴⁴. Moreover it was held in *Scor* that where the reinsurer agrees to follow the reinsured’s settlement, subject to the reinsured having acted bona fide and businesslike manner in assessing the assured’s loss, the reinsurer should follow the settlement of the reinsured if the loss also falls within the reinsurance policy. If a settlement that was entered into by the assured and the reinsured could be binding on the reinsurer, a decision that was given by a competent foreign jurisdiction with regard to the reinsured’s liability should also be accepted as evidence of the reinsured’s liability under the original policy. Therefore it seems reasonable to imply a term into a reinsurance contract that the reinsurer is bound by a foreign court judgment with regard to the reinsured’s liability. Moreover, as noted above, foreign judgments are in most circumstances recognised by the English courts and by so doing such decisions become binding on the parties. Additionally, it is not the case that in *Scor* the Court of Appeal held that in the absence of the follow the settlements clause the Liberian court decision was not

²⁴² [1985] 1 Lloyd’s Rep 312. For the *Scor* case see below, Heading no 6.1.

²⁴³ O’Neill and Woloiniecki para 5-29. It should be noted that in *Commercial Union v NRG* Potter LJ rejected the argument that the decision of a foreign Court could be no more than evidence of the reinsured’s liability: [1998] 2 Lloyd’s Rep 600, 611.

²⁴⁴ However this would be the case only where the contract does not contain a claims co-operation or claims condition clause or where there was no right for the reinsurer to be involved the settlement process. See: *Charman v Guardian Royal Exchange Assurance* [1992] 2 Lloyd’s Rep 607; *Phoenix General Insurance Co of Greece SA v Halvanon Insurance Co Ltd* [1985] 2 Lloyd’s Rep 599.

binding. Even though it is the leading authority on the interpretation of the follow the settlement clause, in *Scor* the Court of Appeal did not need to apply their interpretation in the case as it was held that it was enough that the reinsured had proved its liability to the assured by a judgment. In this case a decision of the Liberian Court established that the reinsured was liable for the loss under the original policy; therefore the Court of Appeal did not need to discuss if the settlement was binding on the reinsurer and held that the reinsured, and therefore the reinsurer, was liable. This in fact shows that, contrary to the abovementioned argument, by recognising the Liberian Court judgment in proving the reinsured's liability to the assured without mentioning the function of the follow the settlements clause, the Court of Appeal in *Scor* also reached a decision that is consistent with the later ruling in *Commercial Union v NRG*.

It is also worth noting that in *Commercial Union v NRG* the Court of Appeal implied the term for all reinsurance contracts irrespective of any follow the settlements clause.

Furthermore, *Wasa v Lexington* in the Court of Appeal also confirms the binding effect of a foreign court decision on the reinsured's liability where the reinsurers were found liable to the reinsured in the light of the Washington Supreme Court decision as to the reinsured's liability to the assured.

Consequently, implying a term that was held in *Commercial Union v NRG* not only seems reasonable but also necessary in performance of reinsurance contracts.

5.2.2 Arbitration Awards

It is extremely common to find arbitration clauses in various types of contract, providing that any disputes arising from those contracts should be resolved by arbitrators. Unless the award goes to appeal,²⁴⁵ it is conclusive between the parties to the dispute, so that the award establishes the reinsured's liability to the assured. The difficulty here is that there is much authority for the proposition that an arbitration award is binding only on the parties to it and indeed that its contents are confidential²⁴⁶. However, it has been accepted that where the original insurance contract contains an arbitration clause, it is implicit in

²⁴⁵ Only in exceptional circumstances can an arbitration award can be appealed; see the Arbitration Act 1996, ss.67-69.

²⁴⁶ *Associated Electric & Gas Insurance Services Ltd v. European Reinsurance Co of Zurich* [2003] 1 All ER (Comm) 253; *Lincoln National Life Insurance Co v Sun Life Assurance Co of Canada* [2005] 1 Lloyd's Rep 606.

reinsurance contracts that the reinsurer agrees to be bound by the arbitration award even if the award is not fully consistent with strict law, subject to the reinsured having argued its case properly in the arbitration and exhausted all rights of appeal²⁴⁷.

5.2.3 Settlements

Assureds' claims do not always lead to legal proceedings between assureds and insurers. In most cases the parties reach agreement as to the claim and settle the amount, and insurers make payment accordingly. In the absence of a follow the settlements clause, in order to make a claim against the reinsurer the reinsured is required to establish that the loss falls within the terms of the original policy and the reinsurance policy. As it was mentioned above, proof of the loss according to the original policy terms is assumed to be met automatically where there is a judgment or award relating to the loss in question. However where the reinsured and the assured settle the claim without a judgment or an arbitration award declaring the reinsured's liability, it requires evidence of liability at law²⁴⁸. In other words, where a reinsured reaches a settlement with the assured this settlement will be binding on the reinsurer if the reinsured proves that the loss was proximately caused by the insured peril and it had no defences to the claim²⁴⁹.

Where a reinsured makes claim against the reinsurer by relying on the settlement, being obliged to prove its liability and quantum may not always be appropriate to the commercial relationship between the parties. For example, where the reinsurer accepts one hundred per cent or most of the proportion of the risk, requiring the reinsured to prove its loss may cause unnecessary formality and delay in the reinsured's recovery. The Market has accordingly formulated clauses that entitle the reinsured to an indemnity where it acted in good faith in assessing the original loss, in other words that it settled the assured's claim honestly believing that the loss was genuine.

²⁴⁷ Butler and Merkin, para C-0007. See also *CGU International Insurance v AstraZeneca Insurance Co* [2007] 1 Lloyd's Rep 142.

²⁴⁸ *Lumbermans Mutual Casualty Co v Bovis Lend Lease Ltd*.

²⁴⁹ In this case if the reinsured can establish that the loss arose from insured perils and the settlement was reasonable, the reinsurer would not be able to challenge quantum: *Traders & General Insurance Association Ltd v. Bankers & General Insurance Co. Ltd* (1921) 9 LI LR 223. The position is the same where the reinsurance policy provides "to pay as may be paid thereon" clause: *Western Assurance Co of Toronto v Poole* [1903] 1 KB 376, 386. See also *Hong Kong Borneo Services Co v Pilcher* [1992] 2 Lloyd's Rep 593, 598.

In the late nineteenth century the formulation that was widely used was “to pay as may be paid thereon”. Nevertheless as will be seen below the clause was not interpreted in the way that it was apparently desired by the parties, and subsequently the market developed the “follow the settlements” clause.

5.3 Settlement Clauses

5.3.1 Early Formulation of Settlement Clauses: “To pay as may be paid thereon”

The use of the “to pay as may be paid thereon” clause goes back at least to the late 19th century²⁵⁰. It is believed that the clause was adopted to provide the opportunity to the reinsured to make claim against the reinsurer where it settled the claim genuinely believing that it was liable to the assured. Hence the proof of actual loss would not be required so long as the reinsured could convince the reinsurer of its honesty and good faith²⁵¹.

The leading authority on the construction of the clause is *Chippendale v Holt*²⁵² where the insured ship was stranded and the insurer paid on the basis that the ship was a constructive total loss. However the reinsurer denied liability by alleging that the reinsured had not proved that constructive total loss had occurred. Therefore the issue was whether the reinsured had to prove its legal liability to the assured before making a claim against its reinsurer. By relying on the “to pay as may be paid thereon”²⁵³ clause counsel for the claimant argued that the clause should be construed literally, and that the sole condition of the defendant’s liability was that the claimant had been satisfied that it was liable and had made the payment in good faith. Mathew J rejected this argument and held that a contract requiring the reinsurer to pay the insurer if he chose to pay whether liable or not would be a wager and not reinsurance. He said that he saw no ground for supposing that the form of the clause was meant to create a liability outside the limits of the original policy.

According to Mathew J’s interpretation the words “to pay as may be paid thereon” would

²⁵⁰ For example see *Uzielli v Boston Marine Insurance* (1884) 15 OBD 11. Clauses providing that the reinsurer would indemnify the reinsured upon mere proof of payment were used in French Reinsurance practice from the early 18th century. See Hoffman, “Common law of reinsurance loss settlement clauses: A Comparative Analysis of the Judicial Rule Enforcing the Reinsurer’s Contractual Obligation to Indemnify the Reinsured for Settlements”, [1994] LMCLQ 52.

²⁵¹ *Gurney v Grimmer* (1932) 44 Ll LR 189, 193, per Scrutton LJ; *Hong Kong Borneo Services Co. Ltd. v Pilcher* [1992] 2 Lloyd’s Rep 593, 597, per Evans J.

²⁵² (1895) Com Cas 197.

²⁵³ The retrocession policy provided: “Being a reinsurance subject to the same clauses and conditions as the original policy and/or policies, and to pay as may be paid thereon, but against the risk of total and/or constructive total loss only”.

seem to assume the existence of liability, proved or admitted, in respect of the loss reinsured²⁵⁴.

The suggestion in the *Chippendale* ruling that the clause required mere payment, subject to good faith, has been described as quite sensible, in that the clause in that case made no reference to liability.²⁵⁵ Nevertheless, following *Chippendale v Holt* it was once more emphasised in *Marten v Steamship*²⁵⁶ that the words “to pay as may be paid thereon” meant only to pay as the reinsured may have been compellable to pay; only having chosen in good faith to pay the assured’s claim was not enough to trigger the clause.²⁵⁷

Moreover, in *Fireman’s Fund Insurance Co v. Western Australian Insurance Co*²⁵⁸ Bateson J pointed out that the contract of reinsurance properly understood was a contract to indemnify against losses which the original underwriter had suffered, but not against gifts that the reinsured might choose to make to his assured²⁵⁹. Having emphasised that the reinsurance policy was a policy covering the liability of the original insurer²⁶⁰, the learned Judge pointed out that if there was no liability on the original underwriter there could not be any liability on the reinsurer. Subsequently, it was held that a “to pay as may be paid thereon” clause did not render the reinsurer bound by the reinsured’s settlement only because the original underwriter paid the assured’s claim by waiving its rights to rely on the unseaworthiness defence²⁶¹.

²⁵⁴ See also *Nelson v. Empress Assurance Corporation* [1905] 2 KB 281; *Merchants’ Marine Insurance Co Ltd. v. Liverpool Marine & General Insurance Co, Ltd* (1928) 31 Ll LR 45. In *St Paul Fire and Marine Insurance Co v Morice* (1906) 22 TLR 449, the “pay to be paid” clause did not feature as a part of the reasoning. However, referring to *Chippendale v Holt*, Kennedy J commented that the reinsurers were under no liability to pay unless the claimants could prove not merely that they were legally liable to the original assured under the original policy, but also that they were entitled to recover from the reinsurers under the terms and conditions and subject to the warranties contained in the policy of reinsurance.

²⁵⁵ Hoffman, 60 fn 53.

²⁵⁶ (1902) Com Cas 195.

²⁵⁷ In *Marten v Steamship* the original policy was against total or partial loss (all risks), whereas the reinsurance was only against total or constructive total loss (CTL). According to the facts Bigham J found that the reinsured made payment for a large partial loss, therefore, the reinsurer was not liable. He was of the view that even if the reinsured classified that payment as CTL, the reinsured cannot claim payment by relying on “to pay as may be paid thereon” clause because in fact they were not liable for CTL. The same rule was applied by Bigham J in *Western Assurance Co of Toronto v Poole*.

²⁵⁸ (1927) 28 Ll LR 243.

²⁵⁹ (1927) 28 Ll LR 243, 251. In this case the reinsured paid the assured even though the ship was unseaworthy and therefore the loss was not covered by the original insurance policy. Bateson J found that the reinsured made payment before investigating the claim properly and with little information as to what had happened.

²⁶⁰ (1927) 28 Ll LR 243, 250.

²⁶¹ Moreover Bateson J rejected the argument that the payment was morally obligatory because no reputable underwriter would rely on the unseaworthiness defence where the claim was small.

As a result of these decisions it became settled law that either as regards liability or its amount the “pay as may be paid thereon” clause added nothing to what would have been the parties’ position in its absence.²⁶²

5.3.2 Follow the Settlements

Given that the “pay as may be paid thereon” clause was not construed by the courts in accordance with the likely intention of the draftsman²⁶³, the Market looked for alternative formulations to bind the reinsurers by the reinsured’s settlements entered into by the reinsured in the belief that it was genuinely liable to the assured.

An example of such an alternative clause was first seen in *Excess Insurance Co. Ltd. v. Mathews*²⁶⁴ where the reinsurer agreed “to pay as may be paid thereon and follow the settlements of the reinsured”. It was held that this formulation carried the “pay to be paid clause” a step further and bound the reinsurer to a compromise on the question of liability, as he was already bound by a compromise on the question of amount.

Nevertheless in a later case, *Sir William Garthwaite (Insurance) Ltd. v. Port of Manchester Insurance Co., Ltd.*²⁶⁵, Scrutton LJ expressed an opinion contrary to that of Branson J. In this case the reinsurance policy provided: “... to follow settlement of the original underwriters subject to the same clauses and conditions as original policy or policies and to pay as may be paid thereon”. Scrutton LJ, who was undoubtedly familiar

²⁶² It is noteworthy that it was held in *Uzielli & Co v Boston Marine Insurance Co* the “to pay as may be paid thereon” clause did not make the reinsurer liable for more than the amount reinsured; nevertheless Lindley LJ indicated that the clause may have caused a result that would not have otherwise been reached. In this case the interpretation of the clause was not the issue, but comments were made as to its function. The reinsurance and retrocession policies contained suing and labouring clauses, and the retrocession contract also provided “to pay as may be paid thereon”. The ship was lost and the original settlement was reached between the assured and the insurer for 88% of the loss. A direct claim on a vessel was settled for 88% of its insured value of £1,500, although the insurer’s liability for salvage costs resulted in an overall payment of 112%. The vessel was reinsured for £1,000, and the insurers sought to recover 112% (ie, £1,120). The Court of Appeal held that the reinsured could recover only 100%; therefore the retrocessionaire was held liable to pay £1000, the whole amount retroceded. The reasoning of Brett MR and Cotton LJ is not clear as to why the retrocessionaire was obliged to pay 100% of the insured amount but not 88% or 112%. Nevertheless, it is seen from Lindley LJ’s judgment that the additional 12% recovery resulted from the “to pay as may be paid thereon” clause. However this case has not been cited as authority on the construction of the clause in later cases.

²⁶³ The Market’s unhappiness as to the ruling in *Chippendale v Holt* was expressed in various proceedings. See for example: *Gurney v Grimmer*; Robert Goff LJ in *Scor* [1985] 1 Lloyd’s Rep 312, 330.

²⁶⁴ (1925) 23 Ll LR 71. In this case the judge found that the original insurers were legally liable to pay their insured, so that his comments on the clause were *obiter*.

²⁶⁵ (1930) 37 Ll LR 194.

with Branson J's view in *Excess v Mathews*, nevertheless treated the two phrases in the same way and held that "to pay as may be paid thereon" was no different from "to pay as may be settled thereon"²⁶⁶.

²⁶⁶ Nevertheless the inconsistency between the two different types of clause came before HHJ Mackie QC in an incorporation context. In *Stronghold Insurance Co Ltd v Bulstrad Insurance and Reinsurance plc* 24 November 2006, unreported, discussed in *Ins LM* March 2008, 1-4, the reinsurer agreed to follow the reinsured's settlements whereas the retrocession agreement was worded "all clauses terms and conditions as original insofar as applicable and to pay as may be paid thereon." The reinsurer contended that the clause was incorporated to the effect that the "follow the settlements" clause overrode the "pay as may be paid thereon" clause so that the reinsurer could make a claim against the retrocessionaire by proving that it acted bona fide and businesslike manner without need to show actual liability. HHJ Mackie QC held that the two clauses produced opposite results and therefore they were inconsistent with each other; consequently they did not meet the requirements of incorporation that were set out in *HIH v New Hampshire* [2001] 2 Lloyd's Rep 161.

CHAPTER 6 CONSTRUCTION OF THE FOLLOW THE SETTLEMENTS CLAUSE

6.1 *The Scor Case*

It appears to be the case that between the 1920's and 1984 almost all reinsurance disputes were referred to arbitration, and it was as late as 1985, that the "follow the settlements" clause first came to be analysed by the courts in *Insurance Co. of Africa v SCOR (U.K.) Reinsurance Co. Ltd.*²⁶⁷ It should be noted that since the reinsured's liability to the assured was established by virtue of a Liberian Court decision, the operation of the clause was not the basis of the decision in this case; however the comments of the Court of Appeal in construing the follow the settlements clause have been taken as definitive ever since.

In *Scor* the reinsurance policy contained a "follow the settlements" clause and, in contrast to *Excess Insurance Co. Ltd. v. Mathews*²⁶⁸ the words "to pay as may be paid thereon" were not attached to the clause. The Court of Appeal emphasised this aspect of the wording of the policy and ruled that the settlements clause was not to be construed in the same way as the "pay as may be paid clause" because the absence of any reference to that clause showed that the parties wished to move away from the outcome in *Chippendale v Holt*²⁶⁹. The Court of Appeal clarified that where the policy contains only a "follow the settlements" clause the reinsurers agree to indemnify the insurers in the event that they settle a claim by their assured if 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 settlement²⁷⁰. Subsequently, where the reinsurer agreed to follow the settlement, it was not appropriate to impose any higher duty on the reinsured²⁷¹.

Scor established that the standard form of the clause relieved the reinsured of the obligation to prove that he was legally liable to pay to the assured. This aspect of the follow the settlements clause was also approved in *Hill v Mercantile & General*

²⁶⁷ [1985] 1 Lloyd's Rep 312.

²⁶⁸ (1925) 23 Ll LR 71.

²⁶⁹ [1985] 1 Lloyd's Rep 312, 330, Mortimer J; *Insurance Co. of the State of Pennsylvania v Grand Union Insurance Co.* [1990] 1 Lloyd's Rep 208.

²⁷⁰ [1985] 1 Lloyd's Rep 312, 330.

²⁷¹ [1985] 1 Lloyd's Rep 312, 330.

*Reinsurance Co Plc*²⁷² where Lord Mustill expressed that the reinsurer cannot be held liable unless the loss falls within the cover of the policy reinsured and within the cover created by the reinsurance. However it was also pointed out in this case that the parties are free to agree on ways of proving whether these requirements are satisfied. The follow the settlements clause is an example of such an agreement²⁷³.

6.1.1 The First Proviso: Within the Scope of the Reinsurance Agreement

In the reinsurance context the Market has tried to find a workable balance between conflicting practical demands, namely the wish to avoid investigating the same issues twice and the need to ensure that the integrity of the reinsurer's bargain is not eroded by an agreement over which he has no control²⁷⁴. Therefore while on the one hand the reinsured is given the right to make a claim against the reinsurer as long as it has acted in a bona fide and businesslike fashion in settling the claim, on the other hand it is necessary that the loss should be proved to fall within the reinsurance coverage. What the reinsured is required to prove is not that the original loss falls within the cover created by the reinsurance but rather that the claim so recognised by the reinsured falls within the risks covered by the policy of reinsurance as a matter of law²⁷⁵. It is generally assumed that this condition is equally applicable where the two contracts provide co-extensive cover. Therefore the second limb of *Scor* is not automatically satisfied unless the reinsured can show that the claim so recognised by it fell within the scope of the reinsurance even though the contracts are back-to-back and the reinsurer is bound by the settlement under the first limb of *Scor*. However, taking into consideration the principle of back-to-back cover together with the operation of the full reinsurance clause, this proposition seems to be doubtful.

As was explained in the first part of this thesis, facultative reinsurance contracts by their nature assume that the cover of the insurance and the reinsurance are identical. This

²⁷² [1996] 3 All ER 865; *Re London County Commercial Reinsurance Office Ltd* [1922] 2 Ch 67.

²⁷³ See also *Assicurazioni Generali SpA v. CGU International Insurance plc* [2004] 2 CLC 122, 126 Tuckey LJ; *Faraday Capital Ltd v Copenhagen Reinsurance Co Ltd* [2007] 1 Lloyd's Rep IR 23, 30; Simon J, *Wasa International Insurance Co Ltd v Lexington Insurance Co* [2007] Lloyd's Rep IR 604; O'Neill and Woloniecki, 5-11.

²⁷⁴ *Hill v Mercantile*.

²⁷⁵ *Assicurazioni Generali SpA v. CGU International Insurance plc* [2003] 2 CLC 852, 870 (Gavin Kealey QC) aff'd [2004] 2 CLC 122, 127.

principle necessitates interpreting the two contracts in the same way²⁷⁶. As Lord Mustill stated in *Hill v Mercantile* a follow the settlements clause operates in facultative reinsurance contracts where the terms of the two contracts are identical and where the parties share the risk and the premium, in order to avoid the investigation of the same issues twice. In this case the interests of the direct insurer and the reinsurer are broadly the same and it seems reasonable to hold the reinsurer to be bound by the reinsured's settlements. However the question here will be whether the presumption of back-to-back cover or the incorporation clause will deprive the reinsurer of its own policy defences where the reinsured acted bona fide and businesslike in a commercial sense but was not liable as a matter of strict law. This was the issue in *Hiscox v. Outhwaite*²⁷⁷ where the assureds were exposed to a massive number of asbestosis-related personal injury claims. Taking into consideration the potential quantum of liability in terms of both the number of parties involved and the amount claimed, in order to ease the procedure to handle such claims, in 1984, a number of asbestosis producers and insurers including the reinsured entered into the Wellington Agreement²⁷⁸. From then until 1988 the Wellington Facility acted as a clearing house for all parties to the Agreement to the effect that the amounts paid in settlement of such claims to individual sufferers were shared rateably between all subscribing producers. Subsequently the reinsured made payment to the producers irrespective of whether that producer had been named as a defendant by a claimant and irrespective of whether that producer could have been legally liable to the claimant. Therefore the reinsured was in the position that it was acting bona fide and businesslike manner in a commercial sense but had made payments under the Wellington Agreement which it might not have been legally liable to make. The syndicate's whole account stop loss reinsurance was on terms which were agreed to be the equivalent of a follow the settlements clause²⁷⁹ and the reinsured argued that the reinsurers were precluded from

²⁷⁶ *Forsikringsaktieselskapet Vesta v Butcher* [1989] 1 Lloyd's Rep 331; *Groupama Navigation et Transports v Catatumbo CA Seguros* [2000] 2 Lloyd's Rep 350; *Wasa International Insurance Co Ltd v Lexington Insurance Co* [2008] 1 CLC 340.

²⁷⁷ [1991] 2 Lloyd's Rep 524.

²⁷⁸ Named after Professor Harry Wellington of the Yale Law School. The Wellington Agreement represented an innovative effort by asbestos producers and their insurers to solve the asbestos litigation crisis. The Agreement established a non-profit claims handling centre that co-ordinated claim payments on behalf of producers. See also below Chapter 10.

²⁷⁹ Article 6: The protection afforded by this Agreement shall as far as applicable be subject to the identical periods, terms, clauses, conditions and warranties as contained in the original policies of Insurance or Reinsurance and/or contracts of Insurance or Reinsurance and in all things falling within the scope of this Agreement the Reinsurers shall share to the extent of their interest the fortunes of the reassured. Article 7: The reassured shall exercise due diligence in dealing with all matters relating to this Agreement it being understood that all loss settlements made by the reassured whether by way of compromise, ex gratia or otherwise shall in every respect be unconditionally binding upon the Reinsurers.

requiring the Syndicate to prove which Wellington Agreement payments represented payments that would have been made in any event in order to discharge liabilities to insured producers under their policies of insurance. Evans J rejected the argument and held that the existence of the “follow the settlements” clause and the presumption of back-to-back principle did not prevent the reinsurer from raising the defences provided by the reinsurance contract itself. The judge expressed the view that it was the only protection for the reinsurer if he was called upon to indemnify the reinsured for bona fide and businesslike settlements but the reinsured was not obliged to pay as a matter of law. Consequently even if the original policy and the reinsurance are back-to-back the reinsurer can still argue that he is not liable for the claim that the reinsured paid without legal liability under the original policy and therefore does not fall within the reinsurance agreement²⁸⁰.

Evans J pointed out that the disputed claims in this case were of the kind that no liability would have existed without the agreement, the claims being asserted against non-insured producers only, who by definition were not within the scope of the reinsurance contract. They did not become insured, and therefore reinsured, claims merely because the Syndicate agreed to treat them as if they were. For these reasons, Evans J found that payments made in respect of claims asserted against non-insured producers were outside the scope of the reinsurance contract.

It is suggested that Evans J’s decision is correct but his reasoning is questionable. It is the case that bona fides in commercial sense does not equate to bona fides in legal sense²⁸¹. Wellington payments could not fall within the second proviso, ie acting bona fide and businesslike, because even though the reinsured’s liability might be reduced in some respects by reason of the sharing of losses, the reinsured knew that under the Wellington Facility it would have to make payments for which it was not legally liable to make. Consequently the payments were not within the original policy and therefore did not fall within the reinsurance. Where the contracts are back-to-back, if the loss falls within the original contract, it is also assumed that it falls within the reinsurance policy terms given that the contracts provide identical cover. If the reinsurance policy contains anything contrary to the original policy or any additional clauses, the contracts are not back-to-back

²⁸⁰ The same principle operated in *Assicurazioni Generali v. CGU* [2004] 2 CLC 122.

²⁸¹ *Commercial Union Assurance Co. Plc. v. NRG Victory Reinsurance Ltd.* [1998] 2 Lloyd’s Rep 600.

in those respects and naturally the reinsurer can rely on its own policy defences. If the settlement is not bona fide and businesslike, it will be outside the first limb of *Scor* and automatically outside the reinsurance policy terms. On the other hand if the loss in fact did not fall within the original policy but the reinsured acted in a bona fide and businesslike in assessing the original loss, the reinsurer would be obliged to pay even though it can be subsequently established that the reinsured was not genuinely liable²⁸². This is the case because the reinsurer agreed to follow the settlements of the reinsured and the construction of follow the settlements clause entitled the reinsured to be indemnified in such cases. Therefore where the contracts provide identical cover and the reinsured has acted bona fide and in a businesslike manner, contending that the reinsured was not genuinely liable thereby enabling the reinsurer to rely on its own policy defences would be tantamount to undermining the construction of the follow the settlements clause.

Nevertheless in *Assicurazioni Generali v. CGU*²⁸³ the Court of Appeal adopted the principle laid down in *Hiscox v Outhwaite*. In *Assicurazioni* the reinsurance was “as original” and the reinsurer agreed to “follow without question the settlements of the reinsured except ex-gratia and/or without prejudice settlements”. The reinsured’s argument was that where the insurance and the reinsurance are on back-to-back terms and where the first proviso of *Scor* is satisfied, the settlement was binding on reinsurers and they could not raise the same coverage issues in defence of the claim on the reinsurance. Therefore the question in *Assicurazioni* became: to what extent does the second proviso preclude reinsurers from raising coverage issues relating to terms which are the same in both the insurance and the reinsurance contracts?

At first instance Gavin Kealey QC²⁸⁴ stated that being “as original” and providing an identical cover together with a “follow the settlements” clause did not mean that the reinsurer was “dictated” to, in the sense of having to indemnify the reinsured for a settlement made in a bona fide and businesslike fashion. If the claim settled was as a matter of law not within the coverage of the original policy, it would also be outside the cover provided by the reinsurance contract. Therefore the judge concluded that in such a case, even though the settlement was bona fide and businesslike, the reinsurer would not be obliged to follow the reinsured’s settlements.

²⁸² *Potter J Baker v Black Sea & Baltic General Insurance Co Ltd* 1995 LRLR 261.

²⁸³ [2004] 2 CLC 122.

²⁸⁴ [2003] 2 CLC 852, 871-872.

The Court of Appeal dismissed the reinsured's appeal. Tuckey LJ, who gave the only reasoned judgment, relied on *Charman v Guardian Royal Exchange Assurance plc*²⁸⁵ and *Baker v Black Sea and Baltic General Insurance Co Ltd*²⁸⁶ in each of which it was ruled that "the reinsurer is not liable if the claim settled does not fall within the risks covered by the policy of reinsurance as a matter of law" where the contracts were assumed back-to-back. He also relied on *Pennsylvania v. Grand Union*²⁸⁷ where Mortimer J was convinced that, with regard to the first proviso of *Scor*, Robert Goff LJ had referred to the reinsurance policy terms but not those of the original insurance which were incorporated into the reinsurance. The judge stated that adopting otherwise would be nullifying the conclusion that Robert Goff LJ reached.

It is true that Robert Goff LJ referred to the reinsurance and not to the original policy terms for the purposes of the first proviso in *Scor* but where the contracts are back-to-back the terms will be identical and there will be no differences between the terms of reinsurance and original insurance. If the reinsurance contains any terms contrary effect to the original policy terms, the contracts will not be assumed back-to-back in that respect and therefore the reinsurer can rely on its own policy terms that differ from those of the original policy.

It is also worth noting that the first proviso of *Scor* was not in issue in the *Charman* case and Webster J in fact concentrated on the second proviso because of the variations in the wording of the follow the settlements clause. In *Baker v Black Sea* Potter J indeed stated that "the reinsurer is not liable if the claim settled does not fall within the risks covered by the policy of reinsurance as a matter of law" but as it is seen in the judgment –like Webster J in *Charman*- Potter J confirmed the construction of the follow the settlements clause which was adopted in *Scor*. More significantly, Potter J stated that the first proviso of *Scor* is subject to the qualification that, where the contracts provide back-to-back cover and the reinsured has settled the claim genuinely believing that it was liable, the reinsurer is obliged to indemnify the reinsured even if it is subsequently proved that the reinsured was not liable.

²⁸⁵ [1992] 2 Lloyd's Rep 607.

²⁸⁶ 1995 LRLR 261.

²⁸⁷ [1990] 1 Lloyd's Rep 208.

Reverting here to Gavin Kealey QC's reasoning, the judge held that even though the settlement was bona fide and businesslike, if the loss did not fall within the original policy terms, according to the back-to-back principle, it will also be outside the cover afforded by the reinsurance, and the reinsurers would not be obliged to indemnify the reinsured only because the settlement was bona fide and businesslike. This approach treats the reinsurance contract as if it did not contain a follow the settlements clause. Where the contract contains such a clause, the rule is that if the reinsured has settled in a bona fide and businesslike manner, be able to make claim against the reinsurer even where it was later proved that the reinsured was not as a matter of law liable to the assured. In other words as long as the reinsured genuinely believed that there was a serious possibility that the loss was covered by the original policy, the settlement is a valid one for reinsurance purposes. Therefore, it appears that the rule adopted in the *Assicurazioni* and *Hiscox v Outhwaite* cases undermines the operation of the follow the settlements clause.

6.1.2 The Second Proviso: Acting in Bona Fide and Businesslike Manner in Settling the Claim

The result of *Scor* is that where the reinsurance contract provides a "follow the settlements" clause the reinsured is relieved from the obligation of proving the actual loss. All that is necessary is that the reinsured took proper and businesslike steps in determining whether there was a serious possibility that the policy covers the assured's claim and there is no defence available against it²⁸⁸.

The issues then become, in what circumstances can the reinsured use the opportunity provided by the settlement clause and who has to bear the burden of proof that the settlement was bona fide and businesslike?

6.2 Burden of Proof

As to the evidentiary effect of the clause, it was stated that the reinsured is entitled to call upon the reinsurer to follow his settlement upon proof that the reinsured has paid his original insured and that the claim against the reinsurer falls within the reinsurance

²⁸⁸ *Municipal Mutual Insurance Ltd v Sea Insurance Co Ltd* [1996] CLC 1515.

policy²⁸⁹. In the absence of any express wording imposing further duties on the reinsured the reinsured's burden of proof is discharged by providing the reinsurers with information and documents which show, but not necessarily in detail, how the claim arose and dealt with; in other words it needs to demonstrate only that the claim and its records were in proper form²⁹⁰. Subsequently, if an issue arises either as to good faith or as to the fact that the settlement was not made in a business-like fashion, the burden must lie upon the reinsurer²⁹¹. The reinsurer must prove either that the compromise was dishonestly arrived at, or that the reinsured has failed to take all the proper and businesslike steps to have the amount of the loss fairly and carefully ascertained²⁹².

The most obvious situation in which it may be argued that the reinsured did not act bona fide and businesslike is where it disregarded defences available under the original policy terms. It was held in *Commercial Union v. NRG*, in the context of a judgment rather than a settlement, that if the reinsured failed to take proper steps to defend the claim in the proceeding the judgment might not be binding on reinsurers. For instance if the reinsured had defences against the assured's claim, such as breach of warranty or duty of utmost good faith but waived the right to rely upon such defences and chose to pay the claim, the follow the settlements clause does not automatically bind the reinsurer by the settlement that was entered into by the reinsured²⁹³. Nevertheless where the assured is in breach of duty of utmost good faith, Morison J in *Bonner v Cox*²⁹⁴ held that given the policy is valid until the insurer avoids it for breach of utmost good faith, the reinsurer is bound to follow the settlement of the reinsured if the reinsured chose not to rely on the breach of the duty of utmost good faith defence. This view is not supportable for two reasons:²⁹⁵ First, it is

²⁸⁹ *Charman v Guardian Royal Exchange Assurance* [1992] 2 Lloyd's Rep 607, 613; See also *Hill v Mercantile* where it was held that if the reinsured cannot prove how he settled the claim with adequate evidence, the reinsurer may not be liable.

²⁹⁰ *Charman v Guardian Royal Exchange Assurance*; Webster J also stated that imposing any further duty to give detailed report and convincing the reinsurer that the settlement was bona fide and businesslike would actually entitle the reinsurer to require his reinsured to prove liability (at 614). See also *Wurtembergische AG Versicherungs Beteiligungsgesellschaft v Home Insurance Co (No.1)* [1997] LRLR 86. The reinsured may also be required to make appropriate investigations and conduct to local lawyers as to the meaning of the original policy *Gan Insurance v Tai Ping Insurance (No.3)* [2002] Lloyd's Rep IR 612.

²⁹¹ *Pennsylvania v. Grand Union*; *Charman v Guardian Royal Exchange Assurance*; Andrew Smith J in *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd*. [2001] Lloyd's Rep IR 667; Potter J in *Baker v. Black Sea & Baltic General Insurance Co. Ltd*.

²⁹² *Per Leggatt J in Scor* [1983] 1 Lloyd's Rep 541, 555 approved by Stephenson LJ, [1985] 1 Lloyd's Rep 312, 322. The reinsurer must bring expert evidence on the matter in order to prove its allegation: *Pennsylvania v. Grand Union* [1990] 1 Lloyd's Rep 208, 217.

²⁹³ *Per Gavin Kealey QC in Assicurazioni Generali v. CGU* [2003] 2 CLC 852.

²⁹⁴ [2005] Lloyd's Rep IR 569, aff'd without comment [2006] Lloyd's Rep IR 385.

²⁹⁵ Butler and Merkin, para C-0008, fn 3.

difficult to conceive why the good faith defence should be treated differently from other defences no matter if the policy is valid until it is avoided. Secondly the reinsured who paid by waiving the available defence cannot be said settled the claim on the basis of liability.

The rule that imposing the reinsurer the burden of proof that the reinsured did not act in bona fide and businesslike is justifiable because obliging the reinsured to prove that it was not negligent in settling the claim would be in fact requiring it to prove its genuine liability²⁹⁶. Moreover, essentially, by a follow the settlements clause the reinsurer puts his trust in the reinsured; therefore, obliging the latter to prove that reliance is justified would be quite inconsistent with the existence of any such trust²⁹⁷.

6.2.1 Appointing a Reputable Loss Adjuster

Reinsureds are to be identified with the conduct of their loss adjusters and any other agents they employ for the purpose of making the settlement²⁹⁸. Therefore reinsureds will be responsible for a failure of the loss adjusters to act with good faith or in a businesslike manner²⁹⁹. This means that the reinsured's conduct will not be regarded businesslike if it simply slavishly follows the loss adjuster's report. When any report is produced by the loss adjuster the reinsured is under a duty to take appropriate steps to put matters right where it is obvious or should be obvious to the reinsured that the report has been prepared inadequately, perhaps because the loss adjuster has assumed something which the reinsured knows to be incorrect or where the report appears to be defective for any other reason³⁰⁰. Consequently, a reinsurer may defeat the application of a loss settlement clause on the ground that the reinsured's loss adjuster failed properly and carefully to investigate and ascertain the loss³⁰¹. The burden of proof that the loss adjuster or any other agent of the reinsured did not act in a businesslike manner will, as stated above, be on the reinsurer.

²⁹⁶ *Charman v Guardian Royal Exchange Assurance* [1992] 2 Lloyd's Rep 607, 613.

²⁹⁷ *Charman v Guardian Royal Exchange Assurance*, at 613; *Pennsylvania v. Grand Union* [1990] 1 Lloyd's Rep 208, 224.

²⁹⁸ *Charman v Guardian Royal Exchange Assurance*, at 612.

²⁹⁹ *Potter J Baker v Black Sea and Baltic General Insurance*.

³⁰⁰ *A Guide to Reinsurance Law*, 239-240.

³⁰¹ Hoffman, 83.

6.2.2 Ascertainment of Liability in Settlements

Where more than one claim has arisen under a reinsurance agreement,³⁰² the parties usually enter into a global settlement agreement where they conclude various claims including the claim that is subject to the dispute. The question is that if the settlement does not indicate the method as to the calculation of figures under the agreement is the reinsurer entitled to reject the claim?

In the insurance context it is generally accepted that a global settlement is binding so long as the assured's liability is established and the settled amount is reasonable³⁰³. The point is not, however, entirely free from doubt. In *Lumbermans Mutual Casualty Co. v. Bovis Lend Lease Ltd.*³⁰⁴, a case involving a direct liability policy, Colman J held that such a settlement was not binding. In this case the assured and the third party entered into a settlement for \$15 million but the settlement did not contain any indication as to the method by which the parties calculated that amount. Colman J looked for any identifiable loss in respect of any identifiable insured eventuality and the lack of those led him to conclude that a global settlement agreement of the nature of that found in the present case did not satisfy the requirement of ascertainment of loss. Moreover, the judge took into consideration that the settlement also covered various counter claims that made identifying the figures more significant³⁰⁵.

Nevertheless, in a later case, *Enterprise Oil Ltd v. Strand Insurance Co Ltd*³⁰⁶, Aikens J stated that there was no precondition that specific claims should be allocated in the settlement itself, so that the assured could recover under the global settlement of insured and uninsured losses so long as it proves the liability. According to the learned Judge if an allocation was required in settlements, it should equally be applied to judgments or awards; consequently, a judgment which also did not meet the requirement would be rendered invalid. He emphasised that judgments rarely descend to the level of particularity

³⁰² This is particularly the case with treaties, although treaties typically do not contain follow the settlements provisions.

³⁰³ *Structural Polymer Systems Ltd v Brown* [1999] CLC 268. See also *P&O Steam Navigation Co v Youell* [1997] 2 Lloyd's Rep 136.

³⁰⁴ [2005] 1 Lloyd's Rep 494.

³⁰⁵ It is worth noting that Colman J rejected extrinsic evidence as proof of that liability.

³⁰⁶ [2006] 1 Lloyd's Rep 500.

which Colman J appeared to suggest therefore, his ruling would cause commercial inconvenience³⁰⁷.

Colman J's decision is not appropriate to commercial practice because the parties usually settle multiple and cross-claims in a global agreement where they do not make any admission of liability or attempt to allocate sums to the various claims. Therefore it was said in the later cases that Colman J's ruling is likely to militate against the global agreements between the parties. It was also described as "technical" for the reason that if the failure to allocate each sum prevents the assured from making a claim, it also deprives him from the ability to prove liability. This view suggests that Colman J's ruling could be applicable where the settlement covers both insured and uninsured losses, so that the mere fact of settling counterclaims would not affect the binding feature of the settlement³⁰⁸.

It should be noted that these two authorities were not in reinsurance cases³⁰⁹ and in fact Aikens J reserved his position as to whether his analysis would be applicable to reinsurance, given that it is not certain if reinsurance is liability insurance³¹⁰. However it was submitted that these rules are equally applicable to the settlements entered into by reinsureds because the logic of the reasoning is that a settlement that not allocate the each claim does or does not establish and quantify the reinsured's loss³¹¹. It should also be remembered that in *Re London County Commercial Reinsurance Office Ltd*³¹² it was held that the reinsured must prove the liability in the same way as the assured had to do. Therefore there seems to be no reason why these principles should not be applicable to reinsureds' settlements. Because *Enterprise* is a High Court decision, it cannot be said that Colman J's view was overruled but on the other hand it should be borne in mind that it has been rejected by trial judges on two separate occasions³¹³.

³⁰⁷ See *AIG Europe (Ireland) v Faraday Capital Ltd* [2007] Lloyd's Rep IR 267, 282: it was not necessary to decide the point but Morison J nevertheless stated that *Lumbermen* was unlikely to be right and had he been forced to state an opinion he would have followed *Enterprise*.

³⁰⁸ Butler/Merkin, para C-0009/2.

³⁰⁹ It should be noted that in *Enterprise* the insurer was a captive, and pursuant to an agreement with the reinsurers, the defence to the claim was effectively conducted in the insurer's name by reinsurers.

³¹⁰ [2006] 1 Lloyd's Rep 500 para 163. See the discussion earlier in this thesis.

³¹¹ Butler and Merkin, para C-0009/2.

³¹² [1922] 2 Ch 67, 80 PO Lawrence J.

³¹³ See *AIG v Faraday* and *Enterprise*. Obviously a Court of Appeal decision is needed to solve the issue conclusively. See *Reinsurance Law and Practice*, para 15.2.7.4.

6.2.3 The Assured's Fraud

In terms of establishing and quantifying its liability to the assured it is necessary only for the reinsured to have acted honestly and professionally in determining that there was a serious possibility that the loss fell within the original insurance coverage. Subsequently, if the assured's claim is shown to have been fraudulent, that should not in principle affect the reinsured's rights against the reinsurer under the follow the settlements clause because matters have to be judged at the date of the settlement. So long as the reinsured acted in bona fide and businesslike manner in settling the claim, even if subsequently it was demonstrated that the assured acted fraudulently, this should not cause the reinsured to lose its rights.

The issue came before the Court of Appeal in *Scor* where the reinsurer received anonymous letters alleging that the fire was set deliberately by the assured, and the reinsurers therefore warned the reinsured to reject the claim otherwise it would not follow any settlements. After the reinsured's refusal to indemnify the assured for the loss caused by the fire, the assured brought an action against the reinsured in Liberia and the Court decided that the claim was not fraudulent. The assured's fraud was not the issue in the proceedings before the English courts but the Court of Appeal nevertheless expressed their opinion on cases where the assured's fraud could be established and held that so long as reinsureds have settled the claim acting honestly and in a proper and businesslike manner the reinsurer is not entitled to reject to follow the settlement even if it is later proved that the claim of the assured was fraudulent³¹⁴. The Court of Appeal suggested that reinsurers may have recourse to their rights of subrogation³¹⁵ arising upon payment of the claim under the policy of reinsurance, in order to seek to rescind the settlement with the assured and to recover the money paid by the insurers under that settlement³¹⁶.

³¹⁴ [1985] 1 Lloyd's Rep 312, 330.

³¹⁵ In *Assicurazioni Generali de Trieste v. Empress Assurance Co Ltd.* [1907] 2 KB 814, (there was no follow the settlements or pay as may be paid thereon clause) the reinsured sued the brokers on the grounds that their employee had fraudulently misrepresented to the insurer that the ships in question came within the scope of the open cover. Pickford J applied *Castellain v Preston* (1883) 11 QB D 380 and held that the reinsurers were entitled to recover the amount of the claim that they had paid, less "the costs" reasonably and properly incurred in pursuing the claim against the brokers. For subrogation, see O'Neill and Woloniecki, para 5-95 et seq.

³¹⁶ [1985] 1 Lloyd's Rep 312, 330.

6.2.4 Proving Liability by the Reinsured in Stop Loss Policies

It has not been settled yet whether or not stop loss policies are reinsurance but cases have shown the need to discuss the operation of the follow the settlements clause in stop loss contracts.

In this kind of agreement the reinsurers accept liability for aggregate ultimate net losses in excess of a fixed monetary amount per annum, subject to an upper limit³¹⁷. In other words the reinsurer protects the reinsured against the risk of a series of losses occurring during one year arising from any one event in excess of the reinsured's retention up to an agreed limit³¹⁸. They are normally written on the basis that all losses above a given figure will be picked up by reinsurers. Hence stop loss reinsurance is not intended to provide protection against individual claims³¹⁹. The reinsurer will be liable after the loss ratio for the year reaches an agreed percentage of the premiums until its limit of liability is reached³²⁰.

*Toomey v Eagle Star Insurance Co Ltd*³²¹ was a case where the policy was in stop loss form and referred itself as "this reinsurance contract". Eagle Star, the reinsurer to close³²², agreed to pay all claims and other outgoings in respect of the run-off of the syndicates' 1965 underwriting year of account including all previous years of account reinsured by that year. The contract provided that settlements to be made monthly on receipt of debit notes to be rendered by the syndicate to Eagle Star. For a long time the agreement was operated without difficulty until a huge increase in claims, mostly arising from personal injury claims as a result of asbestosis, had been made on the syndicates in respect of 1965 and prior years. The issue was whether *Eagle Star* was under an obligation to reimburse the syndicates in respect of claims and other relevant payments regardless of the claimants' proof of liability to the assured.

³¹⁷ Carter, 686.

³¹⁸ Carter, 641; Kiln, 303.

³¹⁹ It is possible, but extremely unlikely, that a single claim would exceed policy limits, but if it did the maximum limit can in principle be applied to payments arising from one single claim: Carter, 686.

³²⁰ Golding, 194.

³²¹ [1994] 1 Lloyd's Rep 516.

³²² Lloyds is organised into Syndicates of Names each of whom accepts a liability for a proportion of the Syndicate's underwriting account. The accounts of the syndicate are prepared on an annual basis and are kept open and not closed until the third year after the year of account. When the accounts for a given year are closed, provision is made to meet outstanding liabilities and credits by reinsuring into the next open year, by means of "reinsurance to close".

The contract provided that claims negotiations should be handled by the reinsured, that settlements should be made monthly on receipt of debit notes from the reinsured, that the reinsured should provide Eagle Star with brief details of any new losses or increased losses which come to their attention and that Eagle Star should be entitled to inspect the records of the reinsured at any reasonable time. Hobhouse LJ found that this contract did not require the claimants to prove liability as would be the case in a true reinsurance or liability insurance contract³²³. His alternative solution for Eagle Star was that they could deny liability either by relying on good faith defence or by exercising their contractual right to be kept informed.

Furthermore Hobhouse LJ said that because of the “pay as may be paid clause” in some reinsurance contracts, establishing liability was required but in this case there was no such clause and liability did not need to be proved.

It is in fact not clear why the Court found it unnecessary to prove liability and whether it was because of the absence of a “pay as may be paid” clause, as was said by Hobhouse LJ in distinguishing this case from *Versicherung*³²⁴ and *Fireman*³²⁵, or whether because stop-loss was not reinsurance. However, it is suggested that his reasoning is incorrect either way. Stop-loss policies cover all losses incurred by the reinsured and are a variation of excess of loss non-proportional cover. Stop loss does look more like an agreement to pay debts once they reach a certain level, rather than reinsurance, but it is accepted as reinsurance by the market³²⁶ and by the regulator³²⁷. As a matter of reinsurance law, there is no inconsistency between the idea of reinsurance and nil retention by the reinsured³²⁸. Moreover reinsurance operates in the same way as liability insurance and, regardless of any discussion of the nature of reinsurance, it is established that in the absence of a follow the settlements provision the reinsured must prove liability.

6.3 When Reinsurers’ Liability Arises

Two different contractual relationships are affected when the risk insured against by a direct policy has occurred. In facultative reinsurance contracts the assured’s loss forms the

³²³ [1994] 1 Lloyd’s Rep 516, 524.

³²⁴ *Versicherungs und Transport A/G. Daugava v Henderson* (1934) 49 Ll LR 252.

³²⁵ *Fireman’s Fund Insurance Co v Western Australian Insurance Co Ltd* (1927) 28 Ll LR 243.

³²⁶ Edelman para, 1-19.

³²⁷ Financial Services Authority, under the Financial Services and Markets Act 2000.

³²⁸ Edelman, para 1-19.

reinsured's claim against the reinsured. Under this mechanism the reinsured cannot claim until its liability to the assured has been established and quantified³²⁹. However this may give rise to disputes as to, for example, the relevant exchange rate for the claim against the reinsurers and also the applicable limitation period.

The exchange rate was the issue in *Versicherungs und Transport A/G Daugava v Henderson* where an English underwriter reinsured a Latvian insurance company against liability under a fire insurance policy on buildings in Riga. A fire occurred and as a result of legal proceeding commenced by the assured judgment was given against the reinsured by the Latvian courts, assessed in the local currency, Lats. The amount was paid to the assured within a month. The issue was, with regard to the reinsurer's liability, whether the sum was to be converted into Sterling at the exchange rate on the day of the fire, or at the date of the settlement of the insurer's liability³³⁰. At first instance Roche J emphasised the follow the settlements clause and stated that the exchange must be calculated as to the exchange rate at the judgment date, January 1932 because the reinsurer was not under any liability at all until there was a settlement to follow, and that did not occur until January 1932³³¹. In the Court of Appeal Scrutton LJ reached the same conclusion but for different reasons. He found it unnecessary to decide if Roche J's reason was correct and expressed the opinion that the reinsurer could not be liable to pay an amount until it had been fixed between the insurer and the assured³³². He also added that if the rate of exchange has been fixed at a date before the insurer's liability to pay is quantified and satisfied, the insurer may recover more than it is actually entitled to, which would be contrary to all principles of insurance indemnity³³³.

In terms of the limitation period in liability insurance, that period starts running from the date when the assured's liability to the third party is established and quantified by virtue

³²⁹ *Home Insurance Company of New York v Victoria – Montreal Fire Insurance Company* [1907] AC 59.

³³⁰ The fire occurred on 11th April 1930 and the insurance payment was made in January 1932.

³³¹ (1934) 48 Ll LR 54, 60.

³³² (1934) 49 Ll LR 252, 253. The parties can expressly agree when the reinsurer's liability arises. In *Feasey v Sun Life Assurance Co of Canada* [2003] Lloyd's Rep IR 637 the reinsurance agreement was drafted on the basis that the reinsurer's liability to make payment arose when the insured contingency happened rather than on which the reinsured's own liability was established. However, *Feasey* turned on a contract specifically drafted to achieve that end.

³³³ (1934) 49 Ll LR 252, 253. In *Fireman's Fund Insurance Co v Western Australian Insurance Co* Bateson J stated that "...a contract of reinsurance is a contract to indemnify against a liability and a payment. There must be both liability and payment, and the precise liability must be covered in each case." After *Henderson* this *dictum* arguably cannot stand: Butler and Merkin, para C-0003.

of judgment, arbitration award or settlement³³⁴. The same principle applies to reinsurance³³⁵. That amount will form the measure of the reinsured's indemnity³³⁶ and this indeed lends further support for the proposition that reinsurance is a form of liability insurance.

6.4 The Necessity of Payment to Trigger the Reinsurer's Liability

The mechanism that was mentioned in the previous paragraphs in reinsurance contracts may lead to an argument that payment by the reinsured to the assured must be a precondition to make claim against the reinsurer³³⁷. This argument may seem to be strong especially where the contract contains "to pay as may be paid thereon" clause.

The issue first came before the court in *Re Eddystone Marine Insurance Company, Ex p. Western Insurance Company*³³⁸ where both the reinsurer and the reinsured were in liquidation and the marine reinsurance policy was expressed to be "...subject to the same terms and conditions as the original policy, and to pay as may be paid thereon". Stirling J expressed the view that the words "to pay as may be paid thereon" did not have a strict grammatical connection with those words which immediately preceded it. The effect of the clause was nevertheless to impose an obligation as to payment on the reinsurers and this obligation should not depend upon to make payment by the reinsured, which would in any event be impossible if the reinsured was insolvent³³⁹. Stirling J also added that in

³³⁴ *London Steamship Owners Mutual Insurance Association Ltd v Bombay Trading Co Ltd, The Felicie* [190] 2 Lloyd's Rep 21; *Lefevre v White* [1990] 1 Lloyd's Rep 569.

³³⁵ *Sphere Drake Insurance plc v Basler Versicherungs-Gesellschaft* [1998] Lloyd's Rep IR 35; *Halvanon Insurance Co Ltd v Companhia de Seguros do Estado de So Paulo* [1995] LRLR 303; *Potter J Baker v Black Sea and Baltic General Insurance Co Ltd* (The point did not arise on appeal). The same principle applies in excess of loss reinsurance: the date on which the excess point is reached establishes the reinsured's liability to pay: *North Atlantic Insurance Co. Ltd. v Bishopsgate Insurance Ltd.* [1998] 1 Lloyd's Rep 459, 462. However see *Feasey v Sun Life* where the test was varied by the express statement that the reinsurer's duty to provide indemnity arose on the happening of the insured peril.

³³⁶ *Potter J Baker v Black Sea and Baltic General Insurance Co Ltd.*

³³⁷ It is in fact the case in *P & I*. See *Firma C-Trade S.A. v Newcastle Protection and Indemnity Association (The Fanti)* [1991] 2 AC 1 where the relevant Club Rules provided "Protect and indemnify members in respect of losses which they as owners of the entered vessel shall have become liable to pay and shall have in fact paid". The House of Lords held that "shall have in fact paid" imposed actual payment by the member/assured as condition precedent to the insurer's liability.

³³⁸ [1892] 2 Ch 423. This case was also mentioned with approval by Scrutton LJ in *Versicherungs und Transport A/G. Daugava v Henderson* (1934) 49 Ll LR 252, 254, and by Evans J, *obiter*, in *Hong Kong Borneo Services Co. Ltd v Pilcher* [1992] 2 Lloyd's Rep 593.

³³⁹ The reinsurer will also be liable for the full amount of the assured's loss. *Re Law Guarantee Trust & Accident Society Ltd* [1914] 2 Ch 617.

order to construe the clause as rendering payment by the reinsured as a condition precedent the clause should clearly so state.³⁴⁰

The matter has more recently come before the courts in the construction of ultimate net loss clauses in excess of loss treaties. Those clauses typically provide that the reinsurers' liability is triggered when the reinsured "shall actually have paid" the assured. For example in *Home and Overseas Insurance Co Ltd v Mentor Insurance Co (UK) Ltd*³⁴¹ the reinsurance policy was drafted as "...only to pay the Excess of an ultimate net loss to the reinsured..." and the policy defined ultimate net loss as "the sum actually paid by the reinsured in settlement of losses...". The reinsured went into voluntary liquidation and made claims against the reinsurer. The latter denied liability and applied for summary judgment declaring that "the amount paid being given by the reinsured", "only to pay..." and "...the sum actually paid by the reinsured in settlement..." required the actual payment by the reinsured in order to make a claim against them. Referring to Stirling J's comments in *Re Eddystone* and also *Re Law Guarantee Trust & Accident Society Ltd* Hirst J expressed that it would be "unjust" and "discordant" with commercial good sense if the reinsurer should be discharged from liability just because the reinsured went into liquidation and not be able to make any payment to the assured especially in a situation where the reinsurer would unquestionably have been liable had the reinsured remained solvent³⁴².

Moreover the word "paid" in the definition of ultimate net loss clause has been construed as "liable to pay" where the reinsured went into liquidation, holding otherwise being contrary to common sense in that it would unduly prolong the reinsured's liquidation³⁴³.

³⁴⁰ Stirling J's decision is consistent with the modern approach: in *Friends Provident Life & Pensions Ltd v Sirius International Insurance Corp* [2005] 2 Lloyd's Rep 517 the Court of Appeal emphasised that in order to be classified as a condition precedent, the clause must expressly so state. Nevertheless, in *Pine Top Insurance Co. Ltd. v. Unione Italiana Anglo Saxon Reinsurance Co. Ltd.* [1987] 1 Lloyd's Rep 476, 478. Gatehouse J noted the general rule that the reinsurer is obliged to pay as soon as the reinsured's liability is, or is capable of being assessed, even though the reinsured has not yet made payment. However the learned judge construed the "to pay as paid thereon" clause as altering the general rule, obliging the reinsurer to indemnify the reinsured on payment of claims by the reinsured.

³⁴¹ [1989] 1 Lloyd's Rep 473.

³⁴² 1988 WL 624156. On appeal the Court of Appeal declined to comment on this point. Parker LJ however, distinguished the case from *The Fanti* as in *Mentor* the contract did not contain any provision which covered the position in liquidation: [1989] 1 Lloyd's Rep 473, 485.

³⁴³ *Re A Company No 0013734 of 1991* [1992] 2 Lloyd's Rep 115.

In *Charter Reinsurance Company Limited v Fagan*³⁴⁴ the House of Lords drew particular attention to the nature of excess of loss reinsurance, and held that within this context the phrase “actually paid” should not be given its ordinary meaning. Their Lordships preferred to read the word “actually” as “in the event when finally ascertained”, and “paid” as “exposed to liability as a result of the loss insured under clause 1”. Lord Hoffman emphasised that words may have different meanings in different contexts and in order to explain that in this policy the words “shall have actually paid” should not be construed in their literal meaning, gave an example of a typical conversation between a husband and wife. He took the word “pay” as an example and said that “A wife comes home with a new dress and her husband says “What did you pay for it?” She would not understand his question in its natural meaning if she answered “Nothing, because the shop gave me 30 days’ credit”³⁴⁵. Lord Hoffman said that there was an ambiguity of meaning of “pay” here because his question was about the amount of money that has changed hands whereas her answer was about the liability that was incurred but had not at the time been discharged. Consequently the House of Lords held that the phrase was not designed to introduce a temporal pre-condition to recovery in the form of disbursement or other satisfaction of the precise net commitment between the assured and the reinsured, but was there “for the purpose of measurement”³⁴⁶.

Obliging the reinsured to have made payment where it is insolvent would clearly be tantamount to releasing the reinsurer from liability just because the reinsured faced financial difficulties. This unjust result was correctly pointed out by Courts and the rule has been settled. The issue in fact does not create real problems where the reinsured is capable of paying the assured’s claim, but is more significant where the reinsured has gone into liquidation.

³⁴⁴ [1997] AC 313.

³⁴⁵ [1997] AC 313, 391.

³⁴⁶ However, the Supreme Court of Ohio held in *Stickel v. Excess Ins. Co. of America* 23 NE 2d 839, 1939 that the phrase “the sum actually paid in cash” in an “ultimate net loss” clause was held to mean that actual payment in cash of a loss by the reinsured for which it is liable was a condition precedent to the duty of the reinsurer to pay (see Appendix).

6.5 Follow the Leader v Follow the Settlements

If there are a number of subscribing underwriters on a risk, a major claim can be settled in one of three ways.

- (1) Each underwriter makes his own decision, some may pay and some may not³⁴⁷.
- (2) All of the underwriters may agree to follow the leader, so if he decides to settle then unless he has acted in bad faith all the others will act accordingly³⁴⁸.
- (3) The underwriters may try to agree what to do. In that case they will form a steering committee which will represent all of them, and that committee will make a decision on payment which will be binding on all the underwriters³⁴⁹.

The question may arise whether the *Scor* provisos are also applicable to case (2), where the policy contains a follow the leader clause. The issue came before Mance J in *Roar Marine Ltd v Bimeh Iran Insurance Co (The Daylam)* where the insurance policy provided “It is agreed with or without previous notice to follow leading British underwriters in regard to. . . settlements in respect of claims. . .” The insurers submitted that a proviso was implied into the “follow the leader” clause that the settlement must have been concluded in a proper and businesslike way by the leader.

Mance J recognised the difference between insurance and reinsurance. In the reinsurance context, the insurer handles and is responsible for settlement of original incoming claims on which he then seeks to rely against his own reinsurer; whereas in the insurance context, there is mutuality of interest between insurers. Following insurers agree with the insured to be bound by settlements handled and made by their leading co-insurer. The insured does not control the way in which the leading underwriters handle or settle the claim; for better or for worse following insurers trust and follow their leader. Following underwriters accept both the advantages and any risks of the leading underwriters’ handling of settlements and of other matters affecting them. The leading underwriter clause was, in *Roar Marine*, limited by the presence of two express exceptions to the following market’s duty to follow settlements, namely ex- gratia and without prejudice settlements. Mance J

³⁴⁷ See *Wasa v Lexington* [2008] 1 CLC 340.

³⁴⁸ *Roar Marine Ltd v Bimeh Iran Insurance Co (The Daylam)* [1998] 1 Lloyd’s Rep 423.

³⁴⁹ *Eagle Star Insurance Co Ltd v Spratt* [1971] 2 Lloyd’s Rep 116 decides that if a steering committee is appointed and all agree to be bound by its decision, then they must honour that decision.

found no basis for further qualifying the operation of the “follow the leader” clause as between the following market and the insured in the manner suggested by the defendants. The qualification would in reality undermine its purpose and operation.

It is uncertain whether the leader acts as an agent for the following market in this situation³⁵⁰. If there is said to be an agency relationship between lead and followers, the usual agency rules will apply. That means that the lead will owe a duty of care to the followers, giving rise to the possibilities of litigation and that the following market are participants in the lead’s professional indemnity insurance so that the claim becomes a circular one. It may be thought that agency principles are therefore not appropriate³⁵¹.

6.6 Re-opening a Settlement

The word “settlement” indicates a concluded binding agreement between the assured and the original insurer, and it does not mean something that can be reconsidered at a later stage by the parties³⁵². Therefore a settlement that is provisional³⁵³ or subject to being reopened cannot be defined as “settlement” for the purposes of a follow the settlements clause³⁵⁴.

In practice most settlements are expressed to be “full and final” and cover “all claims whether known and unknown”, hence subsequent changes in the law render them immune from being reopened³⁵⁵. For example, if it is discovered after the settlement that the assured has suffered some consequential loss he will not thereby be entitled to overturn the

³⁵⁰ A similar issue arises in relation to leading underwriter clauses not concerned with settlements.

³⁵¹ But see *Reinsurance Law and Practice*, para 15.4.1 where it is argued that a leading underwriter will almost invariably take an active role in claims handling, and may find himself in a *de facto* agency position when he takes responsibility for claims handling.

³⁵² *Faraday Capital v Copenhagen Reinsurance* [2007] Lloyd’s Rep IR 23, 30.

³⁵³ Provisional payments that subject to future changes are not absolute and can be challenged later on. However in *Boden v Hussey* [1988] 1 Lloyd’s Rep 423 the retrocessionaire was held liable for a claim settled on the basis of provisional liability subject to adjustment in the event that the reinsured’s liability was either reduced or not proved. In this case an aircraft was lost in an explosion whose cause was not established, so it was unclear whether the loss fell within the scope of the original aviation policy. The reinsurance contract required the reinsurer to make provisional payment, and the reinsurer sought an indemnity from its retrocessionaire under an agreement which indemnified the reinsurer for “losses which may be sustained howsoever” and stated “follow the reinsurer’s settlements”. The Court of Appeal construed the word “losses” as covering payments made both under an established liability and also provisional payments. However, the decision was based on one particular form of retrocession wording and does not establish a general principle: Butler and Merkin, para C-0004.

³⁵⁴ *Rix J in Hill v Mercantile*, approved by the House of Lords, commented stated that there must be a proven settlement and not some other form of acceptance of liability [1996] 3 All ER 865.

³⁵⁵ The validity and amount of the payment can be challenged if the insurer simply asks the insured to sign a receipt without requiring the insured to sign an acceptance declaring that the settlement is full and final: Butler and Merkin, para C-0161.

settlement³⁵⁶. In the same way, if after having reached a settlement it appears that the amount of the insured loss is greater or lesser than the settled amount, this should not lead the settlement re-opened³⁵⁷. However it should be borne in mind that there may be some circumstances that the parties could not have contemplated at the time of the settlement. For instance in *Bank of Credit and Commerce International SA v Ali and Khan*³⁵⁸ House of Lords decided by a majority to re-open a settlement between a bank and dismissed employees by reason of the fact that at the date of the settlement the law had not recognised damages for the manner of dismissal, a head of loss subsequently recognised by the courts, thereby rendering the settlement one tainted by error of law.

This decision will be of some disappointment to those who rely upon the certainty of settlements and commutations, although it should be taken into account that *Bank of Credit v Ali* is an employment case and of a different nature from insurance cases where the assured's heads of loss are generally ascertainable from the outset³⁵⁹. Therefore it cannot be treated as an authority on the re-opening of reinsurance settlements. But in any event it is sensible to draft the settlement as covering all claims "known and unknown" to take steps to protect it against possible re-opening³⁶⁰, and this is indeed the market practice.

Nevertheless, it should be remembered that at common law settlements can be overturned if the parties can prove that they made a fundamental mistake which renders the contract void³⁶¹. Therefore the validity of an insurance settlement can be challenged if the contract that the settlement was based on did not exist in the first place. For example if a reinsurer proves a fundamental mistake in assessing the loss that made them believe that the loss fell within the reinsurance cover whereas it did not,³⁶² such mistake may be interpreted as

³⁵⁶ *Kitchen Design & Advice Ltd v Lea Valley Water Co* [1989] 2 Lloyd's Rep 221; *Fontana v Skandia Life Assurance Ltd* 2000 WL 1841575.

³⁵⁷ *Kyle Bay Ltd v Lloyd's Underwriters* [2007] Lloyd's Rep IR 460.

³⁵⁸ [2002] 1 AC 251.

³⁵⁹ Butler/Merkin, para C-0153.

³⁶⁰ Butler/Merkin, para C-0153.

³⁶¹ *Bell v Lever Brothers* [1932] AC 161. However this common law principle should be considered together with the principle that a contract is void (not voidable) when the subject matter of the contract is not in existence, therefore mistake in quality is not enough to render it void: *Great Peace Shipping Ltd v Tsavliris Salvage (International) Ltd* [2002] 4 All ER 689; *O'Kane v Jones (The Martin P)* [2005] Lloyd's Rep IR 174; *Brennan v Bolt Burdon* [2005] QB 303; *Statoil ASA v Louis Dreyfus Energy Services LP (The Harriette N)* [2008] 2 Lloyd's Rep. 685.

³⁶² See *Norwich Union Fire Insurance Society Ltd v Price* [1934] AC 455 where the insurers made payment on the basis of a mistaken belief that the loss arose from perils insured against. The Privy Council found the mistake "vital" and reopened the settlement.

rendering the settlement void because there was in truth no intention to contract³⁶³. It is also worth noting that in *Kleinwort Benson Ltd v Lincoln City Council*³⁶⁴ the House of Lords abolished the distinction between mistake of law and fact and ruled that the two types of mistake should be analysed in the same way. As a result if the insurer makes payment and subsequently declared his right to avoid the policy or to rely upon the breach of warranty that payment may be prima facie void.

³⁶³ *Bell v Lever Brothers*.

³⁶⁴ [1999] 2 AC 349.

CHAPTER 7 THE SCOPE OF THE FOLLOW THE SETTLEMENTS CLAUSE

7.1 The Reinsured's Costs in Defending the Assured's Claim

The reinsured is under the duty to take all proper and businesslike steps to ascertain that there is a serious possibility that the loss fell within the contract of insurance. However if there are arguable defences available against the assured, the reinsured might have to incur expense in defending the assured's claim. If the reinsured's defence is successful, this would necessarily be to the reinsurer's benefit and therefore one may argue that the reinsurer should share the relevant costs with the reinsured. This may be on the basis of relying on a sue and labour clause or alternatively, especially in proportional reinsurance contracts, the suggestion that the reinsurer and the reinsured are in a partnership relationship and they should share the costs of defending the assureds claim as well as sharing the risk and the premium³⁶⁵.

7.1.1 Sue and Labour Clauses

In the past there have been cases in which the reinsured has based its claim to recover costs on sue and labour clauses. In *Scottish Metropolitan Assurance Co. Ltd. v. Groom*³⁶⁶ the reinsurance policy did not contain follow the settlements or to pay as may be paid thereon clause but provided that "... in case of any loss or misfortune it shall be lawful to the assured...to sue, labour and travel for, in and about the defence, safeguard, and recovery of the said goods and merchandises and ship, &c., or any part thereof, without prejudice to this insurance". The insurer incurred considerable expenses in successfully defending an action by the assured on the ground that the vessel had been deliberately cast away and that the loss was not covered by the policy for that reason. By relying on the sue and labour clause, the reinsured then claimed the cost of defending the assured's action. Alternatively it contended that a term should be implied into reinsurance which required the reinsurer to contribute the expenses incurred by the reinsured in defending the assured's claim. However the Court of Appeal rejected the reinsured's arguments. The Court looked closely at the wording of the sue and labour clause and held that it was

³⁶⁵ *Baker v Black Sea & Baltic General Insurance Co Ltd* [1998] Lloyd's Rep IR 327.

³⁶⁶ (1924) 20 Ll LR 44; cf *British Dominions General Insurance Co Ltd v Duder* [1915] 2 KB 394. *Scottish Metropolitan* was applied by Roche J in *Versicherungs und Transport A/G Daugava v Henderson* (1934) 48 Ll LR 54, 60. It should be noted that the reinsurer in this case agreed to follow the settlements of the reinsured but Roche J did not express any view as to the effect of the follow the settlements clause on claiming costs.

inapposite to cover such claims as it did not contain any provision for payment of costs. As for the implied term argument it was suggested that the term was to be implied from the conduct and action of the defendant or possibly from a practice at Lloyd's.

Nevertheless no sufficient evidence was produced to establish any practice by which the defendant would be bound by implied contract to pay these costs. It can be inferred from the Court of Appeal's comments on the sue and labour clause that the reinsurer may be held liable for the costs but all will depend on the wording of the clause.

7.1.2 Partnership and Implied Term Argument

The partnership argument was the issue in *Baker v Black Sea & Baltic General Insurance Co Ltd*, where the reinsurance policy contained the "Full Reinsurance Clause", and the reinsured emphasised the relationship between the reinsured and the reinsurer and asserted that the reinsurance is an extension of the underlying insurance so that the parties should share the costs as well as the benefits of the contract. The reinsurer was profiting from the defence of these coverage actions and accordingly should contribute to the cost because the proportional nature of reinsurance requires sharing proportionately all aspects of the contract including defence costs.

The Court of Appeal³⁶⁷ distinguished a partnership relationship from reinsurance, pointing out that, in the former, costs and expenses incurred by one partner in the course of the partnership business are incurred for and on behalf of the partnership. Nevertheless in the reinsurance context the legal costs and expenses incurred by the syndicate in investigating claims were incurred by it as principal and on its own account in the course of its own business. Consequently the syndicate had no right to recover any part of such costs from the reinsurer unless the reinsurance contract expressly so provided³⁶⁸.

³⁶⁷ [1996] LRLR 353.

³⁶⁸ For an express term in a reinsurance policy that entitling the reinsured to claim for costs see *Eagle Star Insurance Co Ltd v Cresswell* [2004] Lloyd's Rep IR 537: "In the event of a loss arising to which the underwriters hereon may be liable to contribute, no legal costs shall be incurred on their behalf without their consent being first obtained and if they so consent they shall contribute to the said costs in the proportion that their share of the loss as finally settled bears to the total sum payable. If, however, a settlement of the loss be practicable prior to taking the case into court whether by compromise or otherwise for a sum not exceeding the limits stated in the Schedule hereto, no legal costs shall be payable by the underwriters hereon."

In the House of Lords³⁶⁹ the reinsured continued to rely on its assertions that a term to such effect must be implied in order to give the contract business efficacy, or because it was trade practice in the London insurance market³⁷⁰.

The House of Lords rejected the reinsured's implied term argument, entirely agreeing with the Court of Appeal. As to market practice, the House of Lords pointed out that there would have to be evidence of a universal and acknowledged practice of the market for reinsurers to pay such costs and no such evidence had been produced. The case was remitted to the High Court to see if such evidence existed, but the reinsured did not press its case. There has been no subsequent attempt to argue that there is a market custom to the effect that costs are recoverable on this basis.

As a result of these authorities, it is now settled that unless the policy expressly imposes an obligation on the reinsurer, the reinsured is not entitled to claim the costs that it incurred in investigating the loss or defending the assured's claim and the follow the settlements clause does not include to follow the reinsured's such expenses because unless the parties agree otherwise the expenses of dealing with a loss are no part of the loss itself³⁷¹.

7.1.3 The Relationship with Claims Provisions

Problems arise where the policy contains the full reinsurance clause together with claims provisions³⁷². If the reinsurers declare under a claims co-operation clause that they will not consent to the settlement and force the reinsured to reject the claim, or if they refuse to take over the conduct of the claim under a claims control clause, it may be arguable that a term should be implied into the contract that the cost of defending the claim would be on reinsurers, at least to the extent of their proportion of the risk.

This issue was discussed in *Scor* where the reinsurance policy contained a follow the settlements and a claims co-operation clause. In this case the insured warehouse was

³⁶⁹ [1998] Lloyd's Rep IR 327.

³⁷⁰ See *Wasa v Lexington* [2007] Lloyd's Rep IR 604, where Simon J rejected a claim for defence costs by relying on *Baker v Black Sea* and holding that the reinsurance contract contained no express provision for such coverage and that the reinsured had not attempted to prove a universal practice in the London market in 1977. The point was not appealed.

³⁷¹ Roche J, *Versicherungs und Transport A/G Daugava v Henderson* (1934) 48 Ll LR 54. Costs were not in issue on appeal.

³⁷² For claims provisions, see below Chapter 9.

damaged by fire and the reinsurer received some anonymous letters alleging that the fire was set by the assured deliberately. Subsequently the reinsurers notified the reinsured that they would not pay if the reinsured chose to pay the assured's claim because they suspected that the claim was fraudulent. Therefore the reinsured had to deny liability to the original assured even though it did not possess any evidence of fraud. The assured brought an action against the reinsured and the Liberian court found the reinsured liable and it was also obliged to pay \$58,000 for costs of the proceeding. When the reinsured claimed defence costs from the reinsurer, at first instance, Leggatt J³⁷³ found necessary for business efficacy to imply a term to the effect that where the reinsurer by using his authority refuses to make payment and forces the reinsured to deny the claim the reinsurer should indemnify the reinsured for such expenses even if the costs are beyond the reinsurer's policy limit³⁷⁴. In the Court of Appeal Stephenson LJ emphasised that a contract of reinsurance is a contract of indemnity and the indemnity must cover any payments made by the reinsured which are the reasonably foreseeable result and their Lordships regarded the expenses that the reinsured incurred as a result of the reinsurers' refusal to approve the settlement of the claim as reasonably foreseeable if not direct and inevitable³⁷⁵.

However Robert Goff LJ (Fox LJ concurring) disagreed³⁷⁶. Their Lordships said that Leggatt J had not defined the implication which he was prepared to accept³⁷⁷. Robert Goff LJ was of the view that in order to make the reinsurers liable for such costs, a request in law by the reinsurers, express or implied, to incur the relevant expense or liability, or so to act as to expose themselves to it, must be made. If this condition is met, then an obligation upon the reinsurers to indemnify the reinsureds would arise by virtue of the request, and not as an implied term of the policy. Their Lordships agreed that the attitude of the reinsurers put the reinsureds in a very considerable difficulty; however Goff LJ held that by so doing the reinsurers left to the reinsureds to decide what course of action the latter

³⁷³ [1983] 1 Lloyd's Rep 541.

³⁷⁴ This is different from *Scottish Metropolitan Assurance Co. Ltd. v. Groom* (1924) 20 Ll LR 44 because in *Groom* the reinsured voluntarily incurred the expenses.

³⁷⁵ [1985] 1 Lloyd's Rep 312, 324.

³⁷⁶ O'Neill and Woloniecki prefer the majority view.

³⁷⁷ In fact he did, by saying that if the reinsurer compelled the reinsured to deny the claim, then the latter should bear the cost of defending it proportionate to his liability under the reinsurance contract.

should take following upon the failure or refusal by them to give their approval to the settlement and this did not amount to a request to defend the claim of the assured³⁷⁸.

It seems that there is only one case where the Court of Appeal has expressed willingness to award defence costs, but this case turns on its facts. In *British Dominions General Insurance Co Ltd v Duder*³⁷⁹ the assured's claim was for the constructive total loss of the vessel. The reinsurer argued that it was not a constructive total loss and refused indemnity. The reinsured compromised the claim for 66% of the loss and in the subsequent action brought by the reinsured against the reinsurer it was established that the vessel was a constructive total loss. The reinsured then made a claim against the reinsurer 100% of the loss by contending that the reinsurer should not have benefited from their rejection.

The Court of Appeal put emphasis on the nature of reinsurance, and because reinsurance is a contract of indemnity it was concluded that the reinsured could not recover more than it paid³⁸⁰. Moreover the Court stressed that the reinsured could not make a profit out of the reinsurance. With regard to defence costs Buckley LJ commented that the indemnity was not necessarily confined to 66%: the costs, for instance, of obtaining the compromise at 66% should be added to the 66%. However in this case the Court did not give a firm ruling on the costs because the reinsured did not make it clear what sort of expenses had been incurred and, if they were, for what reason.

It is thus accepted that the only option for the reinsured to be entitled to claim defence costs against the reinsurer is agreeing on this at the outset with the reinsurer³⁸¹. Otherwise the reinsured's claim for costs will fail irrespective of the other terms of the reinsurance³⁸².

³⁷⁸ [1985] 1 Lloyd's Rep 312, 331.

³⁷⁹ [1915] 2 KB 394.

³⁸⁰ The Court also discussed the applicability of *Uzielli v Boston Marine Insurance* (1884) 15 OBD 11, doubts were expressed as to what *Uzielli* actually decided: the case was not regarded as authority for the proposition that the reinsured can recover more than it paid.

³⁸¹ It is suggested that a clause such as "The ceding company have the sole right to settle claims either by way of compromise, 'ex gratia' payments, or otherwise, and all settlements are binding on the reinsurers. The reinsurers should be liable for their share of any costs incurred in resisting or defending any claim" would be an example of an express clause as for costs. See Carter, 135.

³⁸² In fact the reinsurance of a liability policy will normally cover the reinsured's obligations to indemnify the assured both for any liability to the third party and for any defence costs incurred by the assured insofar as they relate to an insured peril although such recovery may be conditional on the reinsured seeking the consent of the reinsurers for the defence of the claim against the assured. For instance in *British General Insurance Co Ltd v Mountain* (1919) 1 Ll LR 605 the reinsured issued a liability policy in the sum of £1000. The reinsured took out a reinsurance policy for £750, with an excess of £250. The direct policy imposed liability on the reinsured for the assured's defence costs. The reinsurers were also liable to indemnify the

The rule seems reasonable because if there is any defence available to the reinsured it has to be asserted, failing which it cannot be said that the reinsured has acted in bona fide and businesslike manner, and if the assured sued the reinsured as a result of rejection of its claim, the reinsured has to defend itself. If the reinsured chose not to plead the defence then it would not be able to establish its liability. It seems that where there is no claims provision, defence costs have no relevance to the assured's loss so that the reinsurer should not be required to share those costs with the reinsured. Even where the policy contains claims provisions, it is equally arguable that the reinsured should bear the expenses itself, despite the fact that such expenses will have to be incurred before the reinsured is able to make a claim against the reinsurers.

It is not clear from *British Dominions v Duder* whether the Court of Appeal would have been willing to hold the reinsurer liable for the costs had the reinsured paid 100% of the loss plus costs. In *Scor* the sum paid plus expenses exceeded the amount reinsured. Therefore it is possible to say that *Scor* left open the possibility of the implication of a term to the effect that the reinsurer might be liable for the reinsured's defence costs so long as it is up to the maximum of the reinsurer's potential contractual liability where the reinsured's claim itself does not reach the reinsurance policy maximum figure³⁸³.

7.2 Interest

If a reinsured fails to settle the claim quickly and it is ultimately held liable to the assured it may have to pay a considerable amount of interest³⁸⁴ and the matter to be discussed is whether the interest should be counted as part of the loss in respect of which the reinsurer undertakes to indemnify the reinsured. The answer was held to be positive in *Excess Insurance Company Ltd. v Mathews*³⁸⁵ but this case should be read in the light of its particular circumstances. In this case even though the risk occurred during the currency of

reinsured for the assured's defence costs, although if the claim against the assured was likely to exceed the reinsured's £250 retention then the reinsurers were only liable for those defence costs if they had given consent for them to be incurred. A claim was made against the assured likely to exceed £250, but the reinsured did not seek the reinsurers' consent to defend the claim. It followed, therefore, that the reinsurers were not liable to indemnify the reinsured for its liability for the assured's defence costs.

³⁸³ Butler and Merkin, para C-0128.

³⁸⁴ Section 35A of the Supreme Court Act 1981 authorises the English courts to award interest on the sum due, and s.17 of the Judgments Act 1838 provides that interest runs from the date of judgment to the date of actual payment.

³⁸⁵ (1925) 23 Ll LR 71.

the original policy the insurers were legally prevented from paying such loss due to the First World War. After the War a protocol between Hungary and Britain made the insurers legally compellable to pay the loss but with interest at a specified rate of exchange at a date after the conclusion of the war³⁸⁶. Therefore it was inevitable that the reinsured and the reinsurer were liable for the interest. However Branson J's comments in this case can be interpreted as meaning that the follow the settlements clause should entitle the reinsured to claim interest from the reinsurer. The learned judge stated that subject to the point on the words "and to follow their settlements" the reinsurers could not be made liable to pay interest merely because the claimants chose to agree to do so or because the claimants became compellable to do so by any act or default of their own other than an express agreement in the original policy. However even though the learned judge put a reservation on the effect of the follow the settlements clause it was not the basis of the decision.

It should also be remembered that the settlement process might be prolonged because the insurers might have refused to give consent to the reinsured's settlement. Even in this situation it is unlikely that reinsurers are to be held liable for the surplus interest because the insurers took the risk under a claims co-operation clause that reinsurers may refuse consent.

7.3 Extra-contractual Liability

A reinsured may be obliged to make payment to the assured in excess of its contractual liability. The reinsured may be exposed to this situation because it failed to settle the claim promptly, thereby rendering itself liable for damages for its negligent act³⁸⁷. This may arise because the reinsured is obliged to make payment within a certain time limit but did

³⁸⁶ In *Excess v Mathews* the claimant insured a mill against fire at Budapest and reinsured the risk at Lloyd's. On 14th August 1914, war was declared between Britain and Austria-Hungary. The mill was destroyed by fire in September 1914. Under clause 12 of the conditions endorsed upon the policy the reinsureds were not bound to pay any loss until the fire companies interested in the property had settled and paid the fire losses. This had in fact been done by 20th February. On 8th March 1915, a "Loss Calculation Protocol" was signed between the agent of the reinsured and one Armin, providing that the agreed sum shall carry interest at 5% from 20th February 1915 until payment and that payment should be made within three months of the conclusion of peace or earlier if the wartime restrictions on payment by British to Hungarian subjects were removed, or if the claimants' assets in Hungary became available. On 4 June 1920 the Treaty of Trianon with Hungary was signed, which by virtue of the Treaty of Peace (Hungary) Act, 1921, obliged the reinsured to pay to the assured with 5% interest to run from the date of commencement of hostilities (or, if the sum of money to be recovered fell due during the war, from the date at which it fell due) until the sum was credited to the Clearing Office of the creditor.

³⁸⁷ It is unclear whether such liability is imposed by English law: Butler and Merkin, para C-0135, C-0136.

not do so in breach of express terms of the contract, as in *Scor*, where the reinsured was obliged to settle the claim in 60 day-period. In *Scor* the claim for extra-contractual liability was rejected because it was in conflict with the claims co-operation clause. However it is yet to be decided whether the position is the same where there are no claims provisions in the reinsurance policy. Moreover in *Scor* the extra-contractual liability was in excess of the reinsurance policy's limit and therefore it is not clear what the position would be if the aggregate sum remains within the reinsurance policy limit³⁸⁸.

In *Scor* the reinsured was also held liable by the Liberian Court to pay \$600,000 for "general damages". Neither Leggatt J nor the Court of Appeal distinguished the reinsured's claim for general damages from its claim for costs. It has been suggested that the Court of Appeal's comment on costs was also applicable to this class of damages³⁸⁹. However, it may be said that an implied term which allows the reinsured to claim punitive damages awarded against it would potentially expose the reinsurer to open-ended liability.

It should be added that in *Scor* the Court of Appeal focused on the effect of claims co-operation clause and not the follow the settlements clause; therefore it is not certain what would be the position if the policy contains only the settlements clause without providing any claims provisions³⁹⁰.

Another possibility is that the reinsured might be obliged to pay exemplary damages representing penalty for settling the claim late. There is no direct authority on reinsurance³⁹¹ in English law but it is arguable that this would be a personal punishment of the reinsured and the award should be borne by the reinsured only³⁹².

As the phrase itself suggests "extra-contractual liability" is not within the reinsurance contract coverage for the reason that it is outside the original policy because it is not a damage to or loss of the subject matter insured. Therefore, it is submitted that it would not be justifiable to hold the reinsurer liable for such amount unless the policy expressly

³⁸⁸ According to *Uzielli v Boston Marine Insurance* (1884) 15 OBD 11 it could be said that if it is within the policy limit the reinsurer may be held liable for such losses.

³⁸⁹ Butler and Merkin, para C-0138.

³⁹⁰ Butler and Merkin, para C-0138.

³⁹¹ See *Lancashire County Council v Municipal Mutual Insurance Ltd* [1997] QB 897 where it was held that public policy for a liability policy would cover both compensatory awards and exemplary damages.

³⁹² Butler and Merkin, para C-0144.

provides otherwise. Furthermore allowing otherwise would also be inconsistent with the nature of reinsurance as it would turn out to be a general liability insurance of the reinsured³⁹³.

7.4 Commutations

As a means of simplifying accounting issues reinsurers and reinsureds may enter into commutation agreements that generally release the parties from accrued and future liabilities in relation to the payment of agreed sums³⁹⁴. Since liability under the reinsurance agreements is replaced by a fresh contract the question here would be what would be the remedy for the breach of the commutation by one party; in other words whether the other party can insist on performance of the commutation agreement or could rely on the terms of the reinsurance contract.

According to general contract law principles if one party is in repudiatory breach of contract the other party has a right to elect whether or not to insist on performing the contract or to treat it as wholly discharged. On the other hand commutation agreements, unless the contrary is provided, release the parties from their obligations arising from the underlying contract and any claim can be brought only for breach of the commutation agreement. However an express term can provide options for the parties. For instance in *Korea Foreign Insurance Co v Omne Re Sa*³⁹⁵ the commutation agreement provided a condition precedent that “in the event the Omne Re makes default in payments of USD 100,000.00 upon execution of this Agreement and/or any of the instalments within 5 to 10 bank working days from [any] reason whatsoever, this Commutation and Release Agreement shall be wholly null and void, and KFIC shall be entitled to reserve its full rights without prejudice to its rights under the Reinsurance Agreements and the claims recoveries”. The agreement was also stated to be “full and final settlement of the outstanding claims under the reinsurance contracts”. The Court of Appeal was of the opinion that the clause was not to be construed as meaning that the commutation agreement was null and void in case of any default payments because such construction

³⁹³ Butler and Merkin, para C-0137.

³⁹⁴ *Colinvaux's Law of Insurance* para 17-22; Evans LJ in *Korea Foreign Insurance Co v Omne Re Sa* [1999] 1 Lloyd's Rep IR 509, 514 particularly in relation to old accounts or when one party is in run-off. *MacGillivray on Insurance Law*, para 33-72; O'Neill/Woloniecki, para 5-54. For an example of a commutation agreement, see *A Guide to Reinsurance Law*, 303-306. The sum in question is calculated by taking into account the claims history, what claims are likely to be made in the future and the likely cost of those claims and what payments are likely to be made in respect of existing claims.

³⁹⁵ [1999] 1 Lloyd's Rep IR 509.

would be contrary to business commonsense and to the commercial purpose of the contract: that approach would enable the reinsurer to render the agreement null and void at any time simply by not making payment during the performance of the agreement. Therefore the effect of the clause was held to be that a default during the interim period gave the reinsured a right to elect whether or not to affirm the compromise agreement and to insist upon performance of its terms or to disregard the agreement and the underlying reinsurance contracts³⁹⁶.

Another question may be whether or not a commutation agreement is a settlement within the meaning of the follow the settlements clause. A similar issue came before the High Court of Singapore in *Overseas Union Insurance Ltd v Home and Overseas Insurance Co Ltd*³⁹⁷ where OUI entered into ten reinsurance contracts with the reinsured then made claim against its retrocessionaire. The reinsurance agreement provided “all loss settlements made by the reinsured, including compromise settlements, shall be unconditionally binding upon reinsurers”. The judge held that the follow the settlements clause did not make the commutation recoverable from the retrocessionaire. A commutation agreement was not a settlement within the meaning of the follow the settlements clause: it is a separate agreement over and above a reinsurance contract.

This decision seems justifiable as the learned Judge correctly stated that a commutation agreement includes the settlement of losses but the reasons for settlement are quite different to a normal settlement because the reinsurer has another priority besides merely settling the individual losses. The agreement will cover various claims and counterclaims that have been accrued and also future liabilities. Therefore in its nature commutations are usually entered into within the context of treaty rather than facultative reinsurance, but even if it is made in the latter context, so long as the loss that the reinsurer reinsured has not been ascertained, it may be the case that the reinsurer will not be obliged to follow the commutation agreement³⁹⁸.

³⁹⁶ The words “*void ab initio*”, were disregarded by the Court of Appeal because the phrase had not been used accurately.

³⁹⁷ [2002] 4 SLR 104.

³⁹⁸ *Lumbermans Mutual Casualty Co. v. Bovis Lend Lease Ltd* [2005] 1 Lloyd’s Rep 494.

CHAPTER 8 OTHER FORMS OF FOLLOW THE SETTLEMENTS CLAUSE

8.1 Variations

The follow the settlements clause is not always worded in its usual form and some variations are often seen. In such cases the question is whether or not the variations release the reinsured from the obligation of acting in bona fide and businesslike manner in settling the assured's claim.

8.1.1 "Without Question" to Follow the Settlement

This was the issue in *Assicurazioni Generali SpA v CGU International Insurance plc*.³⁹⁹ where the reinsurer agreed to follow without question the settlement of the reinsured except ex-gratia and/or without prejudice settlement⁴⁰⁰. The Court of Appeal held that the phrase "without question" clarified rather than qualified or limited the obligations under the follow the settlements clause. By that phrase the reinsurers had entrusted their interests to the reinsureds: the obligation to act in a businesslike manner assumed an even greater significance than it might otherwise possess⁴⁰¹. The Court of Appeal however accepted the possibility that the reinsurer could be deprived of the protection that the *Scor* proviso offers, but they pointed out that in order to do that far clearer and more explicit words than "without question" would be required⁴⁰².

8.1.2 Liable or not liable

The same question came before Webster J in *Charman v Guardian Royal Exchange Assurance*⁴⁰³ with regard to the phrase "liable or not liable" in the clause "...to follow ... in so far as applicable including loss settlements, liable or not liable". In fact Webster J found unnecessary to decide the point, because there was no evidence to suggest that the reinsureds had no belief that they were not arguably liable to the original insured.

³⁹⁹ [2004] 2 CLC 122.

⁴⁰⁰ The clause provided: "As original: Anything herein to the contrary notwithstanding, this Reinsurance is declared and agreed to be subject to the same terms, clauses and conditions, special or otherwise, as the original policy or policies and is to pay as may be paid thereon and to follow without question the settlements of the Reassured except exgratia and/or without prejudice settlements."

⁴⁰¹ Per Tuckey LJ, [2004] 2 CLC 122, 127-128.

⁴⁰² [2004] 2 CLC 122, 128. However it should be noted that the validity of a clause imposing an obligation to the reinsured to follow the reinsured's settlement who paid irrespective of liability would be open to doubt as Mathew J in *Chippendale v Holt* (1895) Com Cas 197 held that such a clause would amount to wagering by the reinsurer.

⁴⁰³ [1992] 2 Lloyd's Rep 607.

Nevertheless he expressed his view that although “liable or not liable” distinguished the clause from a typical follow the settlements clause, those words made no material difference.

8.1.3 Excluded “Without Prejudice” Settlements

In *Faraday Capital Ltd v Copenhagen Reinsurance Co Ltd*⁴⁰⁴ Aikens J discussed the types of settlement falling within the ambit of a follow the settlements clause which excludes “Without Prejudice Settlements”⁴⁰⁵. The judge stated the general rule as that the reinsurers are entitled to insist that the reinsured must prove actual liability under the original policy if the original insurer is not prepared to admit liability, and the judge found that the addition of the proviso concerning without prejudice settlements was an encouragement to the reinsured to give proper and businesslike consideration to its liability to the original assured and to act honestly in settling the claim. In this case the settlement was expressly stated to be a compromise between the parties and that it “...shall not be construed as an admission of coverage under the Subject Insurance Policies”. Moreover the settlement agreement will not be treated as “...a waiver, modification, or retraction of the positions of the Parties with respect to the interpretation and application of the Subject Insurance Policies that are the subject of the Action”. Aikens J found that without admission of liability⁴⁰⁶, was clearly a “Without Prejudice Settlement”⁴⁰⁷ so that the reinsured was unable to recover even though it might otherwise be able to prove its loss.

8.2 Qualified Follow the Settlements Clauses

8.2.1 “Within the Terms of Original Insurance”

In *Hill v Mercantile & General Reinsurance Co Plc*⁴⁰⁸ the reinsurer agreed to be bound by the reinsured’s settlement “providing such settlements are within the terms and conditions of the original policies and within the terms and conditions of this reinsurance.”

⁴⁰⁴ [2007] 1 Lloyd’s Rep IR 23.

⁴⁰⁵ “This Reinsurance is subject to all terms, clauses and conditions as original except as provided for herein, and to follow in all respects the settlements or other payments of whatsoever nature excluding Without Prejudice and Ex-Gratia Settlements made by the Original Underwriters arising out of and in connection with the Original Insurance.”

⁴⁰⁶ See also *Assicurazioni Generali v CGU* where Gavin Kealey QC described without prejudice settlements as “...those where the basis on which they were made was that there was no admission of the existence of any liability under the terms and conditions of the original policy to indemnify.” [2003] 2 CLC 852, para 63.

⁴⁰⁷ [2007] 1 Lloyd’s Rep IR 23, 31. However this should be distinguished from settlements where the reinsured admitted or compromised the liability but the claim as recognised was arguably covered. In this case, the reinsurer would be obliged to pay if the reinsured acted in a bona fide and businesslike fashion even if it was established after trial that the reinsured was not actually liable.

⁴⁰⁸ [1996] 3 All ER 865.

The additional words in the clause were regarded by Lord Mustill as qualifying its effect. According to their Lordships the purpose of the words was to ensure that the reinsurer's original assessment and rating of the risks assumed were not falsified by a settlement which appeared bona fide and businesslike. Contrary to the reinsured's argument that the literal reading of the clause would emasculate its "follow settlements" aspect, their Lordships found that there was ample room for the clause to operate in every situation except where the settlement would bind the reinsurer to a different definition of cover and furthermore the reinsurers should not be bound by settlements which were not intended to be covered⁴⁰⁹.

A similar qualification was in question in *Commercial Union Assurance Co. Plc. v NRG Victory Reinsurance Ltd*⁴¹⁰ where the reinsurance policies provided "All loss settlements by the Re-assured including compromise settlementsshall 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 this Reinsurance". This case was concerned with pollution following the Exxon Valdez accident. The assured applied for summary judgment against the reinsured in the Texas Courts under a policy governed by English law, but then the reinsured settled the claim before trial. The reason was a local lawyer's advice that the reinsured would be unlikely to succeed. According to the lawyer, Mr Reasoner, the case involved a complex construction of terms. But the judge was not experienced and the Texas jury was likely to take a pro-assured approach. Relying on Mr Reasoner's view, the reinsured settled the claim but the reinsurer denied payment on the ground that the reinsured had a clear defence in that the policy covered only "debris" and not oil pollution. Clarke J decided in favour of the reinsured whereas the Court of Appeal reversed the judgment. Both Clarke J and the Court of Appeal agreed that the reinsured must prove his liability in the same manner as the original assured had to. However while Clarke J was convinced that the reinsured had shown that he would have been liable to the assured if the issue had gone to trial, the Court of Appeal disagreed. Potter LJ found that Clarke J fell into error in his approach to the question of whether or not the liability of the claimants to the assured was proved. He said that in the absence of a

⁴⁰⁹ This interpretation was classified as a case "where there has been a significant shift away from the 'generic' approach to the construction of reinsurance contracts": Butler, "Different contract, different terms", *Reinsurance*, September 1996, 62.

⁴¹⁰ [1998] 2 Lloyd's Rep 600.

binding foreign judgment, it was the judge's duty to form his own view whether an arguable defence had been shown by the reinsurer that the reinsured were not liable to the assured according to the applicable law and rules of construction⁴¹¹. Potter LJ stated that the settlement was no doubt reasonable and businesslike, but he pointed out that the follow the settlements clause in this case was worded in a similar way to that of *Hill v Mercantile* and under such a qualified clause establishing that the settlement was businesslike in commercial sense was not enough to make the reinsurer liable⁴¹². Potter LJ was of the view that any court should be reluctant to make predictions as to a decision in another court. Moreover, Mr Reasoner's prediction was not based on the principles of law and was no more than a prediction of human behaviour based on the jury's consideration of different matters in another trial. Furthermore it should not be ignored that it was the reinsured's decision to settle the claim which prevented the jury having the opportunity to consider the case⁴¹³.

8.2.2 “...as far as applicable hereto”

In *Aegis Electrical and Gas International Services Co Ltd v Continental Casualty Co*⁴¹⁴ the original insurance and the reinsurance policies provided different “accident” definitions. The Judge held that the two clauses should be read together, with the effect that the reinsurance definition modified that of the original policy and to that extent the two contracts were not back-to-back. The reinsurance policy also contained “To follow the terms, clauses, conditions, exceptions and settlements of the original policy wording as far as applicable hereto”. Andrew Smith J pointed out that it was not clear whether the phrase “...as far as applicable hereto” referred to terms or to settlements but either way it reflected that the reinsurance cover was not fully back-to-back with the direct cover and its effect was to restrict the effect of the follow the settlements obligation to settlements to which the reinsurance cover was applicable.

⁴¹¹ [1998] 2 Lloyd's Rep 600, 611.

⁴¹² [1998] 2 Lloyd's Rep 600, 612.

⁴¹³ The reinsurers who had –unlike NRG– settled the claim, brought an action against the retrocessionaire in *King v Brandywine Reinsurance Co (UK) Ltd* [2005] 1 Lloyd's Rep 655. The retrocession agreement contained the same follow the settlement clause as in *Commercial Union v NRG*, therefore the retrocedants were required to prove that the loss was both covered by the primary policies and within the terms of the retrocessions. The Court of Appeal held that there was no liability under the direct policy or the reinsurance so that the retrocessionaires were not required to provide an indemnity.

⁴¹⁴ [2008] Lloyd's Rep IR 17.

CHAPTER 9 CLAIMS PROVISIONS

9.1 Claims Co-operations and Claims Control Clauses

In the absence of an express provision in a reinsurance contract, the reinsured is not under any duty to notify the claim to the reinsurer or to seek the reinsurer's consent to settle the claim, and the reinsurer has no right to interfere with the manner in which the reinsured handles it⁴¹⁵. However claims provisions provide such opportunity to reinsurers. There are two types of claims provisions found in facultative contracts. Claims co-operation clauses give reinsurers the right to be involved in the investigation and settlement of the loss⁴¹⁶. The reinsured retains the responsibility for the settlement but its authority will be subject to compliance with any obligations imposed by the contract. Such obligations could be advising the reinsurer within a certain time limit about any circumstances that may give rise to a claim or co-operation with reinsurers in investigating and assessing the claim or contesting the reinsurers consent before reaching a settlement with the assured⁴¹⁷.

Claims control clauses provide even more authority to the reinsurer, in that the reinsured is obliged to pass to reinsurers the control of any negotiations with the direct assured⁴¹⁸. The reinsured may be required to inform the reinsurer of all developments that may affect the cost of claims⁴¹⁹. Such clauses become particularly important where the reinsurance contract is in fronting form⁴²⁰.

⁴¹⁵ *Charman v Guardian Royal Exchange Assurance Plc.* [1992] 2 Lloyd's Rep 607; O'Neill and Woloniecki, para 5-105; Butler and Merkin, para C-0053.

⁴¹⁶ Edelman, para 5.07; *Colinvaux's Law of Insurance*, para 17-24.

⁴¹⁷ See *Gan Insurance Co Ltd v Tai Ping Co Ltd (No.2&3)* [2001] 1 Lloyd's Rep IR 667. Claims co-operation clauses usually specify a time limit to comply with the clause however if the clause does not provide any specified time limit the insured (and reinsured) should comply with the clause within a reasonable time. What is reasonable depends on the facts of each case. See *Hadenfayre Ltd v British National Insurance Society Ltd* [1984] 2 Lloyd's Rep 393, 402; per Lloyd J. See *Bankers Ins v South* [2004] Lloyd's Rep IR 1; Lowry and Rawlings, 251-252; *Shinedean Ltd v Alldown Demolition Ltd* [2006] Lloyd's Rep IR 846.

⁴¹⁸ See the clause in *Scor*.

⁴¹⁹ Carter, 358.

⁴²⁰ *Colinvaux's Law of Insurance*, para 17-24.

9.2 The Nature of Claims Provisions

It is necessary to determine the nature of claims provisions because the remedy for the breach of these clauses will depend on their classification.

In ordinary contract law terms are classified as conditions, warranties or innominate. The effect of breach of warranty will be that the innocent party can claim his damages whereas breach of condition gives right to repudiate the contract in addition to claiming damages⁴²¹. The third category is innominate terms, the remedy for breach depends on the seriousness of the consequences of that breach; the innocent party can claim his damages but can also treat the contract as repudiated if the breach is so serious that goes to the root of the contract⁴²². In an insurance and reinsurance context these terms are construed differently. Breach of warranty discharges the insurer/reinsurer from liability as at the date of the breach. Conditions may be classified either mere conditions, similar to innominate terms in contract law breach of them entitles the innocent party to claim damages or repudiate the contract as a whole if the breach goes to the root of the contract⁴²³ or condition precedent, breach of which gives right the insurer/reinsurer to reject the claim. In this respect it is important to distinguish warranties from conditions precedent. Where the assured is in breach of condition precedent, it does not amount to breach of contract which gives rise to liability in damages, but the breach prevents the assured from making a claim regardless of whether or not the insurer/reinsurer is prejudiced by the breach⁴²⁴. The breach cannot affect the assured's/reinsured's right to pursue a separate claim the conditions relating to which have been complied with: as a result, for example if a condition precedent which requires a claim to be made within a specified period is breached, that claim is lost but other claims are unaffected⁴²⁵. Consequently it appears that breach of condition precedent will cause the assured/reinsured to lose their claim but the policy and the risk itself will remain unaffected⁴²⁶, whereas in case a breach of warranty, the risk terminates as of the date of breach and there can be no future liability under the

⁴²¹ *Chitty on Contracts*, 12-019.

⁴²² *Hongkong Fir Shipping Co. Ltd. v Kawasaki Kisen Kaisha Ltd.* [1962] 2 QB 26.

⁴²³ Edelman, para 6-52.

⁴²⁴ *Shinedean Ltd v Alldown Demolition Ltd.* [2006] Lloyd's Rep IR 846.

⁴²⁵ *Colinvaux & Merkin's Insurance Contract Law*, para B-0086.

⁴²⁶ *Aspen Insurance UK Ltd v Pectel Ltd* [2008] EWHC 2804.

policy. In other words the breach of a condition precedent affects the claim, whereas a breach of warranty affects the risk as a whole⁴²⁷.

The key distinction is nevertheless between innominate terms and conditions precedent. In determining the nature of clause the terminology that is used by the parties is not conclusive but depends on the wording of the policy and the nature of the condition in question. For instance in *Scor* the reinsurance slip contained a claims co-operation clause which provided: "It is a condition precedent to liability under this insurance that all claims be notified immediately to the Underwriters subscribing to this policy and the Reassured hereby undertake in arriving at the settlement of any claim, that they will co-operate with the Reassured Underwriters and that no settlement shall be made without the approval of the Underwriters subscribing to this Policy." Leggatt J divided the clause into two and held that only the first part which related to notification of loss was a condition precedent⁴²⁸. The Court interpreted the rest of the clause as constituting a two-fold undertaking by the reassured in arriving at the settlement of the claim: first, that they will co-operate with the reinsurers, and secondly, that they will not make any settlement without the reinsurers' approval. In the Court of Appeal the reinsurer was held to be liable despite the breach of the claims co-operation clause, because the reinsured had proved its loss. However in *Scor* the reinsured had proved its loss by a judgment against it. The case does not deal with the situation in which the reinsured has entered into a settlement falling within the scope of the follow the settlements clause. It is unclear whether the Court of Appeal's comment that the reinsured has to prove its loss means that a reinsured in breach of the claims cooperation clause is automatically denied the right to rely upon a bona fide

⁴²⁷ *Colinvaux & Merkin's Insurance Contract Law*, para B-141. It should be noted that the concept of repudiation of claim was discussed in terms of breach of claims notification clauses in an insurance context. In *Alfred McAlpine Plc v BAI (Run-Off) Ltd* [2000] 1 Lloyd's Rep 437 it was held that breach of claims notification clause entitles the insurer to reject the claim if the breach is serious but not sufficiently serious to repudiate the policy. This interpretation was adopted in a number of subsequent decisions: *K/S Merc-Scandia XXXXII v Lloyd's Underwriters (The Mercandian Continent)* [2001] Lloyd's Rep IR 802 and *Glencore International AG v Ryan (The Beursgracht) (No.1)*, [2002] Lloyd's Rep IR 335; *Bankers Insurance Co Ltd v South* [2004] Lloyd's Rep IR 1. However in *Friends Provident Life & Pensions Ltd v Sirius International Insurance Corp* [2005] 2 Lloyd's Rep 517 the majority of the Court of Appeal rejected the principle of repudiation of a claim and held that English law did not recognise the concept of partial repudiation. If there was a serious breach of contract then the entire policy was repudiated: if the breach was minor, then the only remedy was damages. Accordingly, given that claims conditions are to be construed as innominate terms only, and given that it is all but inconceivable that breach of a claims condition could ever amount to a repudiation of the policy as a whole, unless the term is drafted as condition precedent at the outset, the only remedy available to insurers is to claim damages. See also *Ronson International Ltd v. Patrick* [2006] Lloyd's Rep IR 194; *Limit (No 2) v Axa Versericherung AG* [2008] Lloyd's Rep IR 330.

⁴²⁸ No breach of notification clause was alleged in *Scor*.

and businesslike settlement or whether the Court of Appeal was simply referring to the fact before it. This point is discussed below.

The clause in *Gan Insurance Co Ltd v Tai Ping Co Ltd (No.2&3)* was worded differently from that of *Scor*. The parties agreed:

“Notwithstanding anything contained in the reinsurance agreement and/or policy wording to the contrary, it is a condition precedent to any liability under this policy that

- a) The reinsured shall, upon knowledge of any circumstances which may give rise to a claim against them, advise the reinsurers immediately, and in any event not later than 30 days.
- b) The reinsured shall co-operate with reinsurers and/or their appointed representatives subscribing to this policy in the investigation and assessment of any loss and/or circumstances giving rise to a loss.
- c) No settlement and/or compromise shall be made and liability admitted without the prior approval of reinsurers. All other terms and criticisms of this policy remain unchanged⁴²⁹.

Comparing this clause to the claims co-operation clause in *Scor*, Mance LJ found that this was more stringent and the draftsmen had separated out the three parts of the clause and had determined to make each into a condition precedent⁴³⁰. Therefore while in *Scor* the breach of claims co-operation clause which was not a condition precedent left it open to the reinsured to prove actual liability against the assured, in *Gan* the clause was classified as condition precedent, breach having the effect that the reinsured could not recover even by proving that he was in fact and in law liable to the assured⁴³¹.

The interpretation of a claims co-operation clause was again the issue in *Eagle Star Insurance Co Ltd v Cresswell*⁴³² where the clause in fact was not expressly stated to be a “condition precedent”. In this case the reinsured agreed

⁴²⁹ It was held that the reinsured would be in breach of the claims co-operation clause by settling, compromising the claim or admitting liability; in other words, any breach in these regards would entitle the reinsurer to reject the claim.

⁴³⁰ [2001] 1 Lloyd’s Rep IR 667, 687.

⁴³¹ [2001] 1 Lloyd’s Rep IR 667, 688.

⁴³² [2004] Lloyd’s Rep IR 537. The policy also contained a typical full reinsurance clause.

- a) To notify all claims or occurrences likely to involve the underwriters within seven days from the time that such claims or occurrences become known to them.
- 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.

Omission however by the company to notify any claim or occurrence which at the outset did not appear to be serious but which at a later date threatened to involve the company shall not prejudice their right of recovery hereunder⁴³³.

The reinsured argued that sub-paragraph (b) conferred an option on reinsurers whereby they could, if they wished, opt to control the negotiation and settlement of claims. That option was triggered by Eagle Star giving notice of claims under sub-paragraph (a) which requires the reinsured to notify all claims or occurrences likely to involve the underwriters within seven days from the time that such claims or occurrences become known to them but the reinsurers did not so opt, so sub-paragraph (b) had no application.

The Court of Appeal disagreed with the reinsured and read the word “shall” as not imposing any obligation on the reinsurer to control negotiations with the original assured but conferred upon them the right to do so. In other words the clause was construed to be an allocation not an option, namely the reinsurer was entitled to be informed when negotiations began so that the reinsurer could decide at that point how the negotiations should be conducted.

As to the nature of the clause the Court of Appeal found that using the words “condition precedent” was not essential and that other clear words could be used to express the consequences of breach⁴³⁴. According to their Lordships the words “reinsurers will not be liable to pay any claim not controlled by them” were clear enough to create the equivalent remedy to a breach of a condition precedent. Additionally, the words “will not be liable to pay any claim” were described as *strong words*⁴³⁵, if not the language of condition

⁴³³ The Court of Appeal commented that this clause was in the nature of a claims control clause. However nothing turned on that classification.

⁴³⁴ In its original form of the Claims Co-operation Clause in the Lloyd’s and Companies Market Policies was expressed as a condition precedent to the liability of reinsurers.

⁴³⁵ Emphasis added.

precedent, at any rate the language of exclusion⁴³⁶. Furthermore, in the second sentence “in this event” was dealt with the situation where there were negotiations in respect of a claim. Therefore the clause was held to mean that “whenever negotiations or settlement have taken place which have not been controlled by the reinsurers, reinsurers will not be liable to pay the relevant claim” unless some reason is shown for excusing the agreed fact that the reinsurers did not control the negotiations or settlement of the assured’s claim⁴³⁷. As a result their Lordships were convinced that the clause was to be construed as condition precedent which deprived the reinsured of the right to make claim against the reinsurer even if it could establish that it was in fact and in law liable against the assured. It was so held because the reinsurers will still have a defence that they were never given that opportunity to control negotiations or the settlement and thus they cannot be liable⁴³⁸.

As may be seen, the use of the words “condition precedent” is not essential to classify the nature of the claims provision. Equally, a clause may not be regarded as a condition precedent even if it says that it is. An example of this can be found in *Dornoch Ltd v Royal and Sun Alliance plc*⁴³⁹ where breach of claims co-operation clause was held not to deprive the reinsured from making a claim against the reinsurer even though the clause expressly provided the words “condition precedent”. Nevertheless, in *Anonymous Greek Co of General Insurances “The Ethniki” v AIG Europe (UK) & Ors.*⁴⁴⁰ the clause was stated to be a condition precedent and it was held that the breach of the clause deprived the reinsured of claiming indemnification from the reinsurer but the reason was not based on the “condition precedent” wording but the effect of the breach namely depriving the reinsurer of reducing or extinguishing the claim by making proper investigations in time.

⁴³⁶ [2004] Lloyd’s Rep IR 537, 548.

⁴³⁷ [2004] Lloyd’s Rep IR 537, 549.

⁴³⁸ In *Eagle Star* this was not an issue but Longmore LJ nevertheless expressed his opinion. See also *Gan Insurance v Tai Ping (No 2&3)* [2001] 1 Lloyd’s Rep IR 667, 688.

⁴³⁹ [2005] Lloyd’s Rep IR 544. Under the reinsurance policy the reinsured was required to give notice of any loss or losses which may give rise to claim under the policy within 72 hours upon knowledge of them. Longmore LJ stated that breach of conditions precedent operated as an exemption to the reinsurers’ liability but in this case the clause was not sufficiently clearly expressed as a condition precedent so as to exempt the reinsurers from liability in case of breach.

⁴⁴⁰ [2000] Lloyd’s Rep IR 343. In this case the clause provided “...it is a condition precedent to any liability under this policy that: (A) the Reassured shall, upon any knowledge of loss or losses which may give rise to a claim under this policy, advise the Underwriters thereof by cable within 72 hours; (B) the Reassured shall furnish the Underwriters with all information available respecting such loss or losses, and the Underwriters shall have the right to appoint adjusters, assessors and/or surveyors and to control all negotiations, adjustments and settlements in connection with such loss or losses.”

Finally it should be noted that the burden of proof that the reinsured is in breach of claims provisions is borne by the reinsurer⁴⁴¹.

9.3 Follow the Settlements v Claims Provisions

The interpretation of the “follow the settlements” clause indicates that the reinsurer trusts the honesty and professionalism of the reinsured. On the other hand reinsurers might want to control the negotiations or the process of dealing with the assured’s claim by the insurer and therefore the reinsurance policy may contain claims provisions as well as a “follow the settlements” clause. Claims provisions impose restrictions on the reinsured’s rights recognised by the common law⁴⁴². Therefore it is necessary to clarify how to resolve the inconsistency that may arise in a policy which contains both clauses.

Leggatt J in *Scor* found that there was no reason to construe the claims provisions as weakening the effect of the follow the settlements clause. So long as the settlement is bona fide and businesslike and the loss falls within the reinsurance cover the reinsurer is obliged to follow the reinsured’s settlement. The Court of Appeal disagreed and found that undertaking by the insurers not to make a settlement without the approval of reinsurers circumscribed the power of insurers to make settlements binding upon reinsurers to the effect that reinsurers would only be bound to follow a settlement when it had received their approval⁴⁴³. The Court of Appeal admitted that such construction would lead the claims co-operation clause emasculating the follow settlements clause⁴⁴⁴; nevertheless their Lordships were convinced that this was what the parties to a policy in this form had agreed.

Moreover, in *Eagle Star Insurance Co Ltd v Cresswell* a typed “no settlement without consent”⁴⁴⁵ clause was found to cut away the printed “follow the settlements” clause in so far as the two clauses were inconsistent.

⁴⁴¹ *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd (No.3)* [2002] Lloyd’s Rep IR 612.

⁴⁴² *Per* Robert Goff LJ *Scor* [1985] 1 Lloyd’s Rep 312, 331. *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd (No.3)*.

⁴⁴³ Naturally, reinsurers may, if they wish, waive that requirement.

⁴⁴⁴ See also *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd*, *per* Longmore J, [2001] Lloyd’s Rep IR 291, 307.

⁴⁴⁵ “No settlement of a loss by agreement shall be effected by the company for a sum in excess of the limits stated in the schedule hereto, without the consent of the underwriters”.

However, it may be thought that there is in fact no necessary connection between a follow the settlements and a claims clause, so the mere fact that the reinsured is in breach of claims clause which is not expressed to be a condition precedent should not deprive the reinsured of its right to insist that its settlement is followed⁴⁴⁶. While it is inevitable that, where the claims provisions are conditions precedent breach of which entitle the reinsurer to reject the claim, the reinsured will not have any right to rely on the follow the settlements clause, but where the clause is not a condition precedent it is open to doubt why the reinsured should not have the rights conferred by the follow the settlements clause⁴⁴⁷. It should also be remembered that *Friends Provident* accepted that a clause which is not a condition precedent is of no significance as regards the claim. Therefore so long as the reinsured acted bona fide and businesslike manner in settling the claim, not seeking the reinsurer's consent should not deprive the reinsured of its right to rely on the follow the settlements clause where the claims provision is not a condition precedent.

9.4 Waiver to Rely upon Breach of Claims Provisions Which Are Conditions Precedent

The issue was authoritatively discussed in *Kosmar Villa Holidays Plc v Trustees of Syndicate 1245*⁴⁴⁸ in the insurance context. In this case the Court of Appeal found that in an insurance contract breach of a claims notification clause which was a condition precedent discharged the insurers from liability automatically. Their Lordships rejected the argument that upon breach of the clause insurers had the right to elect either to accept or reject the claim, so that any representation made by them indicating a willingness to pay amounted to an irrevocable election. However the Court also stated the possibility that, if having been automatically discharged from liability, insurers represented unequivocally to the assured, by words or conduct, that they did not intend to rely upon the breach, and the assured relied on that representation to its detriment, insurers could be estopped from relying on the breach of the claims condition.

⁴⁴⁶ Butler and Merkin, para C-0584. O'Neill/Woloniecki, para 5-26 state that Leggatt J's view in *Scor* is more supportable because there is no logical inconsistency between the "follow the settlements" and "claims co-operation" clauses.

⁴⁴⁷ Butler and Merkin, para C-0584.

⁴⁴⁸ [2008] 1 CLC 307.

The *Kosmar* case was applied by Christopher Clarke J in *Lexington Insurance Co v Multinacional de Seguros SA*⁴⁴⁹ where the reinsurance contract taken out in respect of a liability policy contained a claims settlements clause in the following terms:

Notwithstanding anything contained in the reinsurance agreement and/or the policy wording to the contrary, it is a condition precedent to any liability under this policy that:

- (a) Upon the reinsured being advised of any circumstances which may give rise to a claim against this policy, the reinsured will advise reinsurers of such notification as soon as is reasonably practicable;
- (b) The reinsured shall furnish the reinsurers with all information in respect of such circumstances and shall co-operate with the reinsurers in the adjustment and settlement of the claim.

The reinsured failed to co-operate with the reinsurer in investigating the claim. Following that, the reinsurer sent a letter to the reinsured declaring that because of the breach of claims co-operation clause the reinsurers were treating themselves as discharged from liability. After this letter further negotiation took place between the assured and the reinsured, the effect of which was a waiver by the reinsured of the assured's failure to rely upon a time-bar defence open to it in respect of the third party claim. Christopher Clarke J held that the reinsured was in breach of the claims condition clause by this action. At the trial the reinsured argued that, by virtue of the first letter in which liability had been denied, the reinsurers had waived their right to rely upon any future failure by the reinsured to co-operate. Applying the decision in *Kosmar*, Christopher Clarke J held that where the reinsured was automatically discharged from liability for breach of condition precedent, waiver of the right to rely on the breach by election was not a possibility because there was nothing to elect to waive.

Consequently the only form of waiver open to the reinsured was waiver by estoppel. In other words the reinsured had to prove both that there was an unequivocal representation by the reinsurers that they accepted liability and that the reinsured relied on such representation to its detriment.

⁴⁴⁹ [2009] Lloyd's Rep IR 1.

9.5 Limits on the Reinsurers' Discretion under Claims Clauses

As it was stated above claims co-operation clauses may require the reinsured to seek the reinsurer's consent before entering into any settlements with the assured. It might be thought that in such circumstances there should be an implied term that reinsurers could not withhold approval of a settlement unless there were reasonable grounds for that⁴⁵⁰. In *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd*⁴⁵¹, at first instance Longmore J found it necessary to imply that obligation, to give business efficacy to the contract for the reason that arbitrarily refusing approval of a settlement would defeat the purpose of the reinsurance contract, which was to indemnify the reinsured in respect of his actual liability to his assured⁴⁵².

However in the Court of Appeal Mance LJ expressed his concerns as to the difficulties of identifying criteria by which to determine whether a reinsurer acted on reasonable grounds in withholding approval⁴⁵³. Mance LJ stated that if it had been the case that the reinsured agreed that the reinsurer should have absolute conduct and control of all or any proceedings against the assured⁴⁵⁴, it would make sense to imply a reasonableness requirement. However the clause in *Gan* did not give the reinsurer the power to act on behalf of or to bind the reinsured⁴⁵⁵. As a general qualification Mance LJ declared that the reinsurer should act in good faith in withholding approval by taking into consideration that the facts giving rise to the particular claim and not with reference to extraneous considerations that not connected with the merits of the claim⁴⁵⁶. It should also be noted that such good faith is not an extension of the duty of utmost good faith which is special to insurance law, but arises from the nature and purpose of the relevant contractual

⁴⁵⁰ Reasonableness is required in the insurance context; see *E Hulton & Co v Mountain* (1921) 8 Ll LR Rep 249; *Poole Harbour Yacht Club Marina Ltd v Excess Marine Insurance Ltd* [2001] Lloyd's Rep IR 580.

⁴⁵¹ [2001] Lloyd's Rep IR 291.

⁴⁵² The judge did not find it useful to answer the question of implication of a term obliging the reinsurer to respond to the reinsured's request for approval of a settlement with reasonable promptness. Longmore J found that an unanswered request would be tantamount to a refusal and it was therefore, difficult to foresee circumstances when it actually mattered that a reinsurer did not respond with reasonable promptness: [2001] Lloyd's Rep IR 291, 308.

⁴⁵³ [2001] 1 Lloyd's Rep IR 667, 691.

⁴⁵⁴ As in *Groom v Crocker* [1939] 1 KB 194.

⁴⁵⁵ [2001] 1 Lloyd's Rep IR 667, 693.

⁴⁵⁶ [2001] 1 Lloyd's Rep IR 667, 697. For example, if a reinsurer withholds approval to harm an insurer as a competitor in respect of other business. Cf *Structural Polymer Systems Ltd v Brown* [1999] CLC 268 where it was held that where the criteria for liability had been met it was irrelevant that the settlement had been motivated at least in part by commercial considerations.

provisions. The case thus draws a distinction between reasonableness (which was rejected) and rationality (which was accepted)⁴⁵⁷.

The matter becomes more significant where the claims co-operation clause is a condition precedent breach of which provides defence for reinsurers even if reinsureds establish their liability to assureds. In *Eagle Star Insurance Co Ltd v Cresswell* in order to get around the problem Rix LJ suggested the reinsurer's rejection could amount a waiver, so that in appropriate circumstances a refusal to participate by reinsurers could be construed as a willingness to follow the reinsured's settlements. According to their Lordships waiver could be an issue where the reinsurers chose not to intervene the negotiations. However this suggestion should be read with care because it will be appreciated that waiver may not readily be made out by a simple refusal to join the negotiations. Moreover Rix LJ's second suggestion will be open to doubt where the clause gives the right to the reinsurers to intervene at any time.

It should be emphasised that Mance LJ's test in *Gan* is not a reasonableness test but an implied term whereby reinsurers could not exercise their discretion under a claims provision in bad faith, capriciously or arbitrarily but should use its discretion in a rational fashion by disregarding considerations other than those relating to the claim itself. Moreover in *Eagle Star v Cresswell* Rix LJ took the matter slightly further, and indicated that the duty to act in this way was "as a matter of law in the very essence of the reinsurers' mutual obligation"⁴⁵⁸ of good faith as it was suggested by Longmore LJ in *The Mercandian Continent*. As a result it became apparent that the reinsurers' discretion in handling claims is not unlimited whatever the wording of the policy may be⁴⁵⁹.

9.6 The Time of Notification of Loss

In reinsurance policies where the reinsured insured the liability of the assured both insurance and reinsurance policies are likely to contain a claims control clause which usually provides "Notwithstanding anything herein contained to the contrary, it is a condition precedent to any liability under this policy that the reinsured shall upon knowledge of any loss or losses which may give rise to claim under this policy, advise the

⁴⁵⁷ See also *Anders & Kern Ltd v CGU Insurance plc* [2008] Lloyd's Rep IR 460 where the distinction was noted but not developed.

⁴⁵⁸ [2004] Lloyd's Rep IR 537, 550.

⁴⁵⁹ Merkin, "Follow the settlements and claims cooperation", *Ins LM*, Sept 2004, 6, 10.

underwriters thereof within ... hours”. Whereas such clauses make commercial sense in property insurance policies, problems may arise where policy is one on liability, because the concept of a “loss” is not appropriate to that form of cover⁴⁶⁰. Facultative reinsurance operates similarly to liability insurance and in this context in order to construe such clauses it is necessary to determine the meaning of the word “loss” and the sort of knowledge that the reinsured is required to possess in order to trigger the running of time under the clause.

These were the issues in *Dornoch v Royal and Sun Alliance* and *AIG Europe (Ireland) Ltd v Faraday Capital Ltd*.⁴⁶¹ The facts were slightly different in the two cases, as reflected in their outcomes.

In *Dornoch* Coca Cola and its directors and officers were insured against legal liability. Coca Cola were alleged to have made false statements about their affairs and caused investors to buy their shares at artificially inflated prices. Two different class actions were filed against Coca Cola and named directors in the US, seeking damages for loss sustained by the complainants as a result of the alleged false statements. The reinsurers were not informed of the claims until after the parties had settled them, and the question was whether the loss within the meaning of claims notification clause was the loss that of the claimants who bought shares at artificially inflated prices or the loss of Coca Cola in being required to compensate the claimants for their loss. The Court decided that adopting the former view was correct. Before the decision had been made as to the actions it was not known by anyone that the American claimants had suffered the loss which they claimed or, indeed, any loss because the question whether the claimants had suffered any loss was still in dispute. Therefore the Court was of the opinion that the loss should have been proved in order to describe it as an “actual loss” which might give rise to an insurance claim⁴⁶².

It is noteworthy that Longmore LJ distinguished the position where the claim had been that, as a result of something done by the directors of Coca Cola the value of the stock had

⁴⁶⁰ *Dornoch v Royal and Sun Alliance* [2005] Lloyd’s Rep IR 544, 549-550.

⁴⁶¹ [2007] 2 CLC 844.

⁴⁶² See *Home Insurance Company of New York v Victoria-Montreal Fire Insurance Company* [1907] AC 59 where there was no claims control clause and the Privy Council emphasised that the reinsured could not be expected to notify the claim unless it had been established that it was liable to the assured.

fallen; particularly if the stock had been rendered valueless. Then it might have been clear that there had been a loss and once the reinsured were notified of a claim for that loss, it could be said that they then had knowledge of a loss which might give rise to a claim under the reinsurance policy⁴⁶³. Shortly afterwards, Longmore LJ heard *AIG Europe (Ireland) Ltd v Faraday Capital Ltd* and found that the situation in *AIG* fitted the reservation in *Dornoch*. In this case the insurance policy covered the liabilities of Smartforce and its directors. It was alleged by shareholders that as a result of financial statements, made in this case in the company accounts, the value of the company's shares was artificially inflated beyond their true worth. On 19 Nov 2002, before the stock market opened for business in New York, Smartforce announced that they intended to re-write the previous three years' accounts. On the same day the company's shares lost a third of their value. Shareholders brought actions against Smartforce and its directors. The company's liability insurance policy required notification of a claim within 30 days and that notification was duly given to the company's liability insurers but they did not pass the notice on to their reinsurers. The US action was settled and the reinsured gave notice to reinsurers within 30 days of that settlement but one of the reinsurers, Faraday, relied on the wording of the Claims Co-operation clause in the reinsurance policy which provided : "...it is a condition precedent to any liability under this policy that a) The reinsured shall upon knowledge of any loss or losses which may give rise to a claim, advise the reinsurers thereof as soon as is reasonably practicable and in any event within 30 days...".

The decision was for the reinsurers. There was no event - apart from such artificial inflation - in *Dornoch* which could trigger any loss; the fall in that occurred in the share value could have arisen as a result of normal market fluctuation or market perceptions of the normal kind whereas in *AIG* there was a positive event happened on 19th November 2002 that covered a substantial drop in the share price after the announcement on that day of the intention to restate the company's account. Consequently *AIG* knew about the claim when Smartforce notified them in late December 2002; therefore *AIG* should have notified reinsurers within 30 days of that date.

As may be seen, there is no certain rule as to the loss which triggers the notification period starts running because it changes according to the facts of every case and it depends on the interpretation of the particular circumstances in question.

⁴⁶³ [2005] Lloyd's Rep IR 544, 551.

9.7 Implied Term: Inspection of Records

Inspection clauses are in fact more typical of reinsurance treaties than of facultative contracts, although the latter may also contain clauses requiring the reinsured to keep records to demonstrate that negotiations were carried out in bona fide and businesslike manner⁴⁶⁴. The effect of breach of such clauses is no different from that of other claims provisions, namely the English courts will not allow the reinsurer to repudiate the claim itself unless the clause was drafted as a condition precedent⁴⁶⁵.

Nevertheless reinsurance contracts do not always contain inspection of records clauses and the question that has arisen is whether a term providing a right to inspection should be implied into the contracts. Such an implication has been found appropriate in facultative obligatory treaties. In *Phoenix General Insurance Co of Greece SA v Halvanon Insurance Co Ltd*⁴⁶⁶ Hobhouse J expressed the view that the necessity to imply a duty to investigate claims properly arose from the undertaking by the reinsurer to “follow the settlements” of the reinsured⁴⁶⁷. Consequently, the duty should apply to all reinsurance contracts that contain a settlement clause⁴⁶⁸.

However it should be taken into consideration that Hobhouse J’s implication was based on the facultative/obligatory nature of the contract in question. It is especially noteworthy that in these types of contract no restrictions are imposed on the reinsured as to its right to choose whether or not to cede the risk insured. On the other hand the reinsurer does not have any equivalent right and is obliged to accept all risks that has been ceded by the reinsured. For these reasons, in this type of reinsurance, the judge found it appropriate to imply the duty on the reinsured “to conduct the business involved in the cession prudently, reasonably carefully and in accordance with the ordinary practice of the market.” However

⁴⁶⁴ Exercising the right to inspect is subject to a reasonableness requirement: *Welch v Royal Exchange Assurance* [1939] 1 KB 294; *Napier v UNUM Ltd* [1996] 2 Lloyd’s Rep 550. It should not be exercised in bad faith and in an excessive or “fishing” fashion: *Société Anonyme d’Intermediaries Luxembourgeois & Anor v Farex Gie* [1994] CLC 1094.

⁴⁶⁵ In fact inspection clauses are not really appropriately drafted as conditions precedent, as in treaties the reinsurer is entitled to examine the reinsured’s books and records whether or not there has been a loss: *Colinvaux’s Law of Insurance*, para 17-15.

⁴⁶⁶ [1985] 2 Lloyd’s Rep 599. According to the learned judge the reinsured is obliged to, inter alia, “keep full, proper and accurate accounts showing at all times the amounts due and payable by the plaintiffs to the defendants and by the defendants to the plaintiffs under the contract”. The case was applied in *Economic v Le Assicurazioni d’Italia* unreported: see *Bonner v Cox* [2006] Lloyd’s Rep IR 385.

⁴⁶⁷ [1985] 2 Lloyd’s Rep 599, 614.

⁴⁶⁸ *MacGillivray on Insurance Law*, para 33-69; Edelman para 3.45.

such an implication may not be appropriate in non-proportional reinsurance. Having recognised the nature of the contract in *Phoenix*, the Court of Appeal in *Bonner v Cox*⁴⁶⁹ expressed that Hobhouse J could not possibly have intended to say that the implied terms applied to all forms of reinsurance⁴⁷⁰, although the implied term under consideration in *Bonner* was not an inspection clause but rather a term whereby the reinsured undertook to write business with reasonable care.

In *Bonner v Cox* the Court of Appeal did not make clear whether they overruled Hobhouse J's decision with regard to proportional contracts. However looking into detail of the two decisions it seems that implied term theory is not supportable. For instance in *Phoenix* it was held that the relevant obligations must be regarded as continuing ones, just as is the obligation of the utmost good faith whereas, in *Bonner v Cox*, the Court of Appeal emphasised that the duty of utmost good faith was only pre-contractual. Moreover, according to Hobhouse J the relevant terms have to be implied so as to require the reinsured to conduct his business in a proper and business-like fashion and the reinsurer may also be able to find out what his rights are. On the other hand the Court of Appeal in *Bonner v Cox* were of the opinion that the reinsurers could protect themselves by way of using other defences rather than implying terms into the contract. The reinsurers are entitled to agree on the policy terms at the outset that could provide enough protection for them. The Court of Appeal found it inappropriate to make reinsured responsible for the reinsurers' failure to take such steps. More importantly Hobhouse J ruled that the implied terms were to be innominate and therefore the remedy for breach of them must depend on the nature and gravity of the relevant breach. Nevertheless in *Bonner v Cox* the Court of Appeal put emphasis on the difficulties in determining whether damages would always cancel out the claim entirely or whether the defence of contributory negligence would be taken into account.

It should be noted that even if implied terms are found justifiable, they will not be classified as conditions precedent⁴⁷¹ and the breach of record-keeping and inspection obligations will not deprive the reinsured of a claim against the reinsurers and the

⁴⁶⁹ [2006] Lloyd's Rep IR 385.

⁴⁷⁰ In *Albany Life Assurance Co v De Montfort Insurance Co plc* (1995 unreported see Butler and Merkin, para C-0578) it was found to be inappropriate to imply a term that required the assured to co-operate with the insurer in the investigation of any claim and to make available the claim file for insurers' inspection. See also *Société Anonyme d'Intermediaries Luxembourgeois v Farex Gie*.

⁴⁷¹ *Baker v Black Sea & Baltic General Insurance Co Ltd*. [1995] LRLR 261.

reinsured can still rely on the follow the settlements clause. However it could avail the reinsurers to claim for damages if they prove that they suffered loss as a result of the breach⁴⁷². Nevertheless such remedy should be considered with the effect of the reinsurers' right to rely on a defence regarding the inspection clauses and the clause itself would remove the prospect of separate loss for the breach of such clauses⁴⁷³.

⁴⁷² *Charman v. Guardian Royal Exchange Assurance Plc.* [1992] 2 Lloyd's Rep 607, 616.

⁴⁷³ Butler and Merkin, para C-0656.

PART C SETTLEMENT CLAUSES IN THE US REINSURANCE MARKET

CHAPTER 10 INTRODUCTION TO REINSURANCE AND FOLLOW THE FORM CLAUSES

Settlement clauses are also widely used in the US reinsurance market. It is adopted that in the absence of a follow the settlements clause the reinsured would have to deal with the proof of the loss and the amount of it twice, at the insurance and reinsurance level. Therefore it is found necessary to use settlement clauses to prevent unnecessary procedures and delays for reinsured's claims⁴⁷⁴. In the following chapters the nature and scope of the settlement clauses and their relationship with claims co-operation and notification clauses will be examined. It should be noted that most reinsurance disputes in the US are resolved by arbitration⁴⁷⁵. Consequently there are relatively few judicial decisions, and state courts tend to refer to decisions from other state jurisdictions as well as their own therefore, it is necessary to look at law overall in the US without making any limitations to any State's law⁴⁷⁶.

10.1 Nature of Reinsurance

Unlike the position in England, in the US there is little controversy as to the nature of reinsurance, which is defined as "simply insurance for insurance companies"⁴⁷⁷ where the insurable interest is the potential liability of the insurer under the original policy⁴⁷⁸. In other words, insurance companies purchase reinsurance to insure their liabilities under direct policies⁴⁷⁹. In *Central Nat. Ins. Co. of Omaha v. Prudential Reinsurance Co.*⁴⁸⁰ reinsurance was defined as a contract whereby one insurer for a consideration contracts with another to indemnify it against a loss by reason of a risk which the latter has assumed under a separate and distinct contract as the insurer of a third party.

⁴⁷⁴ See Chaffetz and Moss, "Follow the Fortunes and Allocation: An Update", (2009) 16 *Journal of Reinsurance* 55, 57.

⁴⁷⁵ *Employer Reinsurance Corp. v. Laurier Indem. Co.* 2007 WL 1831775 (MD Fla).

⁴⁷⁶ *Houston Cas.Co. v Lexington Ins. Co.*, 2006 US Dist, LEXIS 45027.

⁴⁷⁷ *Travelers Cas. and Sur. Co. v. Constitution Reinsurance Corp.* 2004 WL 2387313 (ED Mich); *Continental Cas. Co. v. Stronghold Ins. Co., Ltd.* 77 F 3d 16, 1996.

⁴⁷⁸ Pollack, M, "The Reinsurance Contract", *Reinsurance Contract Wording*, 3rd Ed, Ed by R.W.Strain, 1998, 23.

⁴⁷⁹ *North River Ins. Co. v. CIGNA Reinsurance Co.* 52 F 3d 1194 CA 3 (NJ), 1995.

⁴⁸⁰ 241 Cal Rptr 773, 1987.

It is submitted that reinsurance is not co-insurance, where separate insurers share the same insured risk, nor is it a substitution of one insurer for another⁴⁸¹. Nor it is a partnership between the reinsured and the reinsurer or a separate joint venture between them⁴⁸².

10.1.1 Privity of Contract

It is generally accepted that there is no privity between assureds and reinsurers, and reinsurers are under no obligation to pay the assured even if the reinsured becomes insolvent⁴⁸³.

The reason for the rule is said to be inherent in the nature of the reinsurance contract, because reinsurance is the ceding by one insurance company to another of all or a proportion of its risks for a stipulated proportion of the premium, in which “the *liability of the reinsurer is solely to the reinsured*, the ceding company, and in which contract the *ceding company retains all contact with the original insured, and handles all matters prior to and subsequent to loss*”. This principle was stated in *Reid v. Ruffin*⁴⁸⁴ where the assured, Ruffin, negligently caused serious injury to Reid. The reinsured did not settle the claim despite an offer from Reid’s counsel, and at the trial the jury awarded Reid a sum considerably higher than the amount put forward prior to the trial. The reinsured subsequently became insolvent; Reid argued that he was entitled to recover directly from the reinsurers for their own bad faith in refusing to sanction the reinsured to settle, and effectively asked the Court to abandon the privity requirement and to impose a duty of good faith on the reinsurers towards the original insured. The court noted that an insured is

⁴⁸¹ *New Appleman Guide*, 40.01.

⁴⁸² *New Appleman Guide*, 40.01. Cf *Inland Mut. Ins. Co. v. Peerless Ins. Co.* 152 F Supp 506, aff’d, 251 F 2d 696 CA4 1958.

⁴⁸³ *American Employers’ Ins. Co. v. Swiss Reinsurance America Corp.* 275 F Supp 2d 29 D.Mass., 2003, aff’d 413 F 3d 129 CA1(Mass.), 2005; *Gantt v. American Cent. Ins. Co.* 68 Mo 503, 1878; *Carlson Holdings, Inc. v. NAFCO Ins. Co.* 205 F Supp 2d 1069 D.Minn., 2001; *Stickel v. Excess Ins. Co. of America* 23 NE 2d 839 Ohio 1939; *New York Bowery Fire Ins. Co. v. New York Fire Ins. Co.* 17 Wend 359, 1837; *Jackson v. St. Paul Fire & Marine Ins. Co.* 1 NE 539, NY 1885; *Employers Reinsurance Corp. v. American Fidelity & Cas. Co.* 196 F Supp 553, 1959; *Donaldson v. United Community Ins. Co.* 741 So 2d 676 La App 3 Cir, 1999; *Strong v. Phoenix Ins. Co.* 62 Mo 289, 1876; *Unigard Sec. Ins. Co., Inc. v. North River Ins. Co.* 4 F 3d 1049 CA2 (NY), 1993; *Travelers Cas. & Sur. Co. v. Gerling Global Reinsurance Corp. of America* 419 F 3d 181 CA2 (Conn), 2005; *Travelers Cas. and Sur. Co. v. Certain Underwriters at Lloyd’s of London* 96 NY 2d 583, 2001; *North River v. CIGNA*; *Central Nat. Ins. Co. of Omaha v. Prudential Reinsurance Co.* 241 Cal Rptr 773 1987; *American Bankers Ins. Co. of Florida v. Northwestern Nat. Ins. Co.* 198 F 3d 1332 CA11 (Fla), 1999; *Colonial American Life Ins. Co. v. C.I.R.* 491 US 244, 1989. Cal.Ins.Code § 623 states that “[t]he original insured has no interest in a contract of reinsurance.” However, a reinsurer and reinsured may agree to entitle the assured to make direct action against the reinsurer, most often when the reinsured is insolvent. Such a clause is called “cut-through” clause and this can be conceived of an express grant of third-party beneficiary status of the putative non-party direct insured. See Staring, G S, *Law Of Reinsurance*, 1993, §16:2; *New Appleman Guide*, 40.05[1].

⁴⁸⁴ 503 Pa 458, 1983.

not notified of the reinsurance, has no contact with the reinsuring company, and is generally not a party to the contract. Because the reinsurer has not assumed a contractual duty to represent the original insured, he has no obligation to which the duty of good faith can attach. The reinsurer's only obligations are toward the reinsured and arise under contract. Therefore the assured was held to have no enforceable rights against the reinsurers.

Despite accepting the rule in *Reid v Ruffin*, in *Venetsanos v. Zucker, Facher & Zucker*⁴⁸⁵ it was pointed out that whether or not a reinsurer has a duty to the primary insured depends on the degree of the reinsurer's control over the decisions concerning settlement with the third party claimant. Accordingly, where the reinsurer, under the reinsurance contract or otherwise, takes charge of and manages the defence of suits against the original insured, the reinsurer may be held to be "privy" to the action. Here, Homestead reinsured Mutual 100 percent and Homestead carried out the insurance investigation, reimbursed Mutual for claims and had absolute control of the final claim adjustment. This was, therefore, a fronting operation. Accordingly, Homestead was treated as though it had the obligations of a primary insurer to the assured. The court distinguished *Reid v. Ruffin* where the primary insurer had retained most of the risk, reinsuring only twenty five percent, and controlled the settlement negotiations.

It is worth mentioning that the policy wording may be interpreted as permitting the assured to bring suit against the reinsurer. In *Ott v. All-Star Ins. Corp.*⁴⁸⁶ it was held that the excess-of-policy-coverage clause added to the original reinsurance agreement made the reinsurer the liability insurer of the insurer, allowing the assured to make a direct claim against the reinsurer for the reinsured's alleged tort of bad faith.

It should also be noted that the principle that the assured has no rights against the reinsurer does not relieve the reinsurer from liability when the reinsured has become insolvent. In *Consolidated Real Estate & Fire Ins. Co. v. Cashow*⁴⁸⁷ it was held that the original assured has no kind of claim against the reinsurer; the reinsured remains solely liable on the original insurance, and alone has any claim against the reinsurer. Hence, if the original insurer becomes insolvent and the assured is paid only a small dividend from his

⁴⁸⁵ 271 NJ Super 459, 1994.

⁴⁸⁶ 99 Wis 2d 635, 1981.

⁴⁸⁷ 41 Md 59, 1874.

remaining assets, the reinsurer is still liable to pay the whole amount of the reinsurance to the person administering the insolvency of the original insurer without deducting the dividend, and the assured has no claim in respect of the money so paid. Similarly, in *Cashau v Northwestern Nat. Ins. Co*⁴⁸⁸ it was emphasised that the financial condition of the reinsured is not to be taken into account in the computation of the amount to be paid on the policy of reinsurance. The condition in the reinsurance policy that “in case of loss the company shall pay pro rata at and in the same time and manner as the reinsured” cannot mean that in case of the insolvency of the reinsured the reinsurer can only be obliged to pay the pro rata the dividends of the assets of the reinsured upon the claim of the assured. The condition means that the reinsurer shall pay at and in the same time and manner as the reinsured company shall pay or be bound to pay according to its policy,⁴⁸⁹ and the reinsurer shall have all the advantages of the time and manner of payment specified in the policy of the reinsured - otherwise the reinsurer’s policy would not be the contract of indemnity intended, and endless litigation might ensue.

10.1.2 Insurable Interest

The direct assured has no interest in the contract of reinsurance⁴⁹⁰. Equally, the reinsured has no property right in respect of the subject matter insured. The reinsured renders itself liable for the loss that assured may suffer and it acquires an insurable interest to the extent of that liability but it was only for the risk reinsured⁴⁹¹.

Reinsurance and insurance contracts are independent of each other. However in order to provide concurrency between the policies and also to simplify the procedure for reinsureds in making claim from reinsurers it is also the case in the US reinsurance markets that, respectively, follow the form and follow the fortunes clauses are in use.

10.2 Follow the form clauses

The “follow the form” clause is used in order to express the match between the reinsurance and insurance coverage. *Aetna Cas. and Sur. Co. v. Home Ins. Co.*⁴⁹² considered a standard wording of that clause: “This Policy is subject to the same

⁴⁸⁸ 5 F Cas 270 CC Wis 1873.

⁴⁸⁹ This is sometimes referred to as a “simultaneous settlements” clause.

⁴⁹⁰ *Strong v. Phoenix* 62 Mo 289, 1876; *Carlson Holdings v. NAFCO*. 205 F Supp 2d 1069 DMinn .

⁴⁹¹ *Jackson v. St. Paul Fire* 1 NE 539, NY 1885.

⁴⁹² 882 F Supp 1328, SDNY, 1995.

warranties, terms and conditions (except as otherwise provided herein) as are contained in or as may be added to the Underlying Coverage prior to the happening of an accident or occurrence, whichever is applicable, for which claim is made hereunder”. The purpose of using the “follow the form” clause is to limit expressly the reinsurance to the terms and conditions of the underlying policy and to provide that the reinsurance will cover only the kinds of liability insured by the original policy⁴⁹³. It should be noted that there is no standard Full Reinsurance Clause in this market and it is not always the case that a follow the form clause is used together with a follow the settlements or follow the fortunes clause⁴⁹⁴.

10.2.1 Follow the form – concurrency between the reinsurance and the original insurance

It was pointed out that concurrency between the policy of reinsurance and the reinsured policy is provided through a follow the form clause. It is presumed in such a policy that, unless an exclusion is spelled out, the reinsurance contract will be construed as offering the same terms, conditions and scope of coverage as exist in the underlying policy⁴⁹⁵. In *Travelers Cas. & Sur. Co. v. ACE American Reinsurance Co.*⁴⁹⁶ the parties disagreed as to whether the three-year contracts provided coverage up to a single aggregate limit for the three-year period or for three annual aggregate limits. The reinsurance policy contained a follow the form clause which stated that the terms and conditions of liability of the Certificates shall “follow” those of the Policies, “except as otherwise specifically provided.” The Second Circuit noted that the reinsurance agreement did not provide anything contrary to the underlying insurance and that both the original insurance and reinsurance provided “each occ.-agg” to describe the relevant coverage period. Therefore the concurrency between the two contracts remained in place, the reinsurance policy should be interpreted the same way as the original policy and the only reasonable interpretation of the phrase “each occ.-agg.” in the three-year certificates was that each three-year certificate provided coverage for three annual aggregate limits.

Concurrency between the reinsurance and the underlying insurance has also been defined in terms that, through a follow the form clause, the reinsurance policy looks back to the

⁴⁹³ *North River v CIGNA* 52 F 3d 1194 CA 3 (NJ), 1995.

⁴⁹⁴ The follow the form, follow the fortunes / settlements clauses and also claims provisions are worded in detail in the US Market. See the Appendix for clauses not fully quoted in the text.

⁴⁹⁵ *Aetna v Home Ins.* 882 F Supp 1328, SDNY, 1995.

⁴⁹⁶ 201 Fed Appx 40 CA2 (NY), 2006 (applying New York law).

original insurance policy. In *Commercial Union Ins. Co. v. Swiss Reinsurance America Corp.*⁴⁹⁷ the primary layer insurance provided coverage to Grace under five successive one-year policies for personal injury and property damage up to \$1 million per occurrence. Commercial Union's excess liability policies provided coverage in the amount of \$5 million for each "occurrence". The Commercial Union policies included "follow-the-form" clauses stating that "the terms, conditions and limitations of this policy will not be construed any more restrictive [sic] than the terms, conditions and limitations of Underlying Insurance." Swiss Re issued three multi-year facultative reinsurance policies to Commercial Union, thereby agreeing to share a specified portion of Commercial Union's liability to Grace. Swiss Re agreed to take fifty percent of the first \$1 million, so that its cover for any one occurrence giving rise to a claim exceeding \$1 million was \$500,000. The reinsurance policy also contained a follow-the-form clause which provided that "-except as "otherwise specifically provided" in the certificate, Swiss Re's liability would "follow" or "be subject" to the "terms and conditions" of Commercial Union's policies". Thus, according to the First Circuit, through "follow-the-form clauses", Swiss Re's policies looked back to Commercial Union's, and the latter's policies looked back to the original policies with Grace.

Commercial Union settled Grace's pollution claims based on an "annualisation approach", on the unarticulated premise that \$5 million per-occurrence limit in its multi-year umbrella policies applied separately to each policy year. Swiss Re contested the allocation and argued that the leakage at any one site during the three-year period covered by its certificate comprised a single "occurrence." If the leakage during the three-year period comprised one occurrence, then Commercial Union's liability to Grace for a three-year leak would be capped at \$5 million and Swiss Re's liability to Commercial Union would be \$500,000 (fifty percent of the first \$1 million).

The court held that Swiss Re's argument would have been stronger if the reinsurance contract had not contained a follow the form clause. The First Circuit stated that, as established by *Aetna*, concurrency between the policy of reinsurance and the reinsured policy is presumed where a reinsurance policy contains a follow the form clause. Under Swiss Re's "follow-the-settlements" clause it was bound to accept this pro-annualisation reading of the Commercial Union policy for purposes of establishing Commercial Union's

⁴⁹⁷ 413 F 3d 121 CA1 (Mass), 2005.

liability to Grace. According to the First Circuit, Swiss Re's "follow-the-form" clause was deemed to extend this reading into the parallel language in Swiss Re's own certificates subject only to any clear limitation to the contrary in the Swiss Re documents which defined single occurrence as including a "continuous or repeated exposure to conditions" and did not include additional language "within a single year."

It must be noted that providing a concurrent coverage does not strictly depend on the follow the form clause. In *Philadelphia Ins. Co. v. Washington Ins. Co.*⁴⁹⁸ the issue was whether the reinsurance and original policies were co-extensive in the absence of a follow the form clause. In this case it was argued that the reinsurance and the original insurance policies were not back to back for the reason that one was a time policy and the other was for a specific voyage. The Supreme Court of Pennsylvania rejected this argument and held that both policies were issued on the same day; while the insurer was bound for any voyage the vessel might make or commence within five months from the date indicated, the reinsurers were bound only for a voyage that was capable of being finished short of the five months. Therefore the court found that the reinsurers' risk was lesser, and was included within that of the reinsured. The court also emphasised that if the insurance be against perils of the sea, the reinsurance must be against perils of the sea; but whilst it may not be against more, it may be against fewer, perils of the sea than the original insurance.

10.2.2 Incorporation of Terms

10.2.2.1 Incorporation of arbitration clauses

It was stated that a "follow the form" clause in a policy of reinsurance incorporates by reference all the terms and conditions of the reinsured policy, except to the extent that the reinsurance contract by its own terms specifically defines the scope of coverage differently⁴⁹⁹. Unlike English law, in the US, incorporation of terms has not caused controversy. Nor, there is much dispute as regards the terms that can be incorporated or not such as incorporation of ancillary terms or incorporation of terms that determine the scope of coverage. There are, however, a few authorities in which incorporation of some dispute resolution provisions has been questioned. In *Progressive Cas. Ins. Co. v. C.A. Reaseguradora Nacional De Venezuela*⁵⁰⁰ incorporation of an arbitration clause from the reinsurance into the retrocession agreement was at stake. In this case the retrocession

⁴⁹⁸ 23 Pa 250, 1854.

⁴⁹⁹ *Aetna v. Home Ins.* 882 F Supp 1328, SDNY, 1995.

⁵⁰⁰ 991 F 2d 42 CA2 (NY), 1993, applying New York law.

agreement was “Subject to Facultative Reinsurance Agreement”. The Facultative Reinsurance Agreement (FRA) contained an arbitration clause that “Any question or dispute arising between the contracting parties concerning the interpretation of this Reinsurance Agreement, which cannot be otherwise arranged shall be settled by arbitration in London, England.”

The district court held that a trial was necessary to determine whether the Policy identified the FRA with sufficient specificity to incorporate it by reference into the Policy. However, the Second Circuit found that the Policy specifically and directly identified the FRA by name. The use of capitalised letters in the phrase “Subject to Facultative Reinsurance Agreement” indicated to any reasonable person that a specific document was being referenced. If the retrocessionaire’s broker was unfamiliar with the FRA, it should either have asked the reinsured or objected to the provision before signing the Policy. Having failed to do so, the retrocessionaire’s broker, as a very sophisticated party, was deemed as a matter of law to have understood and agreed to all aspects of the Policy. The Second Circuit further noted that under New York law, in the absence of fraud or other wrongful conduct, a party who signed a written contract was conclusively presumed to know its contents and to assent to them, and he was therefore bound by its terms and conditions. The Second Circuit also considered the wording of the arbitration clause, which provided for arbitration of disputes between “the contracting parties”, which, according to the Court, did not restrict the clause referring to the immediate parties to that contract by name. In other words, the clause was worded broadly enough to allow its effective incorporation by reference into other contracts.

Another point worth noting as regards the wording of the clause is that US reinsurers contend that because the FRA’s arbitration clause refers to disputes “concerning the interpretation of this Reinsurance Agreement,” the clause applies only to disputes concerning the FRA, even where the clause has been incorporated into another agreement. The Second Circuit noted that a standard clause such as “All disputes arising out of this agreement shall be arbitrated” could not be incorporated because “this agreement” would be held to refer only to the original agreement containing the clause; however the FRA clause was held to incorporate the arbitration clause because if the retrocessionaire’s

argument was to be accepted, it would be almost impossible to incorporate any arbitration clause into a second agreement⁵⁰¹.

10.2.2.2 Incorporation of choice of law clauses

This was the issue not in the reinsurance context but in an excess of loss reinsurance dispute. In *AT&T v. Clarendon Am. Ins. Co.*⁵⁰² the Superior court of Delaware accepted the argument for incorporation of a choice of law clause in the fourth-level excess policy into the fifth-level excess of loss policy by virtue of the follow the form clause which was worded, follow form to “the policy of the Primary Insurer, together with all the ... terms ... contained in ... any Underlying Excess Policy(ies).”) The fourth-level policy was one of the “Underlying Excess Policy(ies).”) The court also noted that the parties to the dispute were sophisticated parties who understood the meaning and effect of including the New York choice of law provision in the fourth-level excess policy and the ramifications it would have on the excess policies that “follow form.” While the fourth-level excess policy provided that New York law shall govern the contract, the primary policy was silent. Thus, the policies did not contain any inconsistent provisions which would otherwise preclude the incorporation.

10.2.2.3 Incorporation of a time bar clause

In *Faneuil Hall Ins. Co. v. Liverpool & London & Globe Ins. Co.*⁵⁰³ the clause “this policy is subject to the same risks, conditions, mode of settlement, and in case of loss, payable at the same time, and in same manner, as the policies reinsured” was held not to incorporate the various terms in the reinsured policies as to risks, conditions, mode of settlement, time and manner of payment in case of loss. As a result of that the time bar clause was held not to be incorporated into the reinsurance policy.

10.3 Follow the form – endorsement or modification of the original policy

After the reinsurance policy has been taken out and the reinsurer has agreed to follow the form of the original policy, if the reinsured extends the original policy cover, a question will arise as to whether or not the reinsurer is also automatically bound by the endorsement because of the “following form” clause. An early opinion on this issue stated

⁵⁰¹ Which is the position in England.

⁵⁰² 2008 Del Super LEXIS 220.

⁵⁰³ 153 Mass 63, 1891.

that the follow the form clause did not authorise the reinsured to charge the reinsurers by the assumption of a new risk of a different character, or to materially enlarge the existing one⁵⁰⁴.

The position has not changed; in a more recent case, decided under New York law, it was held that extended period of endorsement provision in business interruption policy issued by reinsured was not “term” or “condition” of policy, but rather was separate and distinct endorsement to policy, and thus was not within “following form” clauses of reinsurance contracts providing that reinsurers’ liability would follow terms and conditions of underlying policy. The issue came to the Southern District of New York Court in *United Fire & Cas. Co. v. Arkwright Mut. Ins. Co.*⁵⁰⁵ where the insurer, Arkwright, issued to Warnaco a first-party property damage and business interruption insurance policy covering Warnaco’s property throughout the US and Mexico. Arkwright’s standard policy form provided basic business interruption coverage. The extended period of endorsement (EPI) lengthened the period of interruption in the Warnaco Policy for an additional 270 consecutive days beyond the time afforded by the basic business interruption coverage. An earthquake occurred on 17 January 1994 which damaged Warnaco’s property. The business interruption loss sustained by Warnaco was \$12,644,243 between the date of the earthquake and the time that the property was ready to be reoccupied (July 1994). The loss was sustained under the EPI endorsement was \$5,726,998 which represented the amount of business interruption loss sustained by Warnaco in the 270 days subsequent to July 1994, ending in April 1994⁵⁰⁶ and resulted primarily from the difficulty in re-categorising stock and the consequent inability to fill orders and a resultant loss of market share. The reinsurer argued that the Endorsement contained in the Arkwright policy of insurance issued to Warnaco was not reinsured by the reinsurers and that the reinsurers were not liable under their Certificates of Facultative Reinsurance. Balis, a reinsurance intermediary, placed facultative reinsurance for the Warnaco Policy with Western Re and Axa Re. Both reinsurance certificates provided a “following form” clause to the effect that the liability of the reinsurer shall follow the terms and conditions of the reinsured’s policy furnished to the reinsurer at the effective date of the reinsurance certificate, unless otherwise specifically provided herein by indorsement made a party of this certificate. By

⁵⁰⁴ *Manufacturers’ F. & M. Ins. Co. v. Western Assur. Co.* 145 Mass 419, 1888.

⁵⁰⁵ 53 F Supp 2d 632 SDNY, 1999.

⁵⁰⁶ In the decision it is read 1994 but there must be a mistake because from July 1994, subsequent 270 days should be April 1995, not 1994.

taking into consideration that facultative certificates do not necessarily constitute the entire agreement among the parties to a reinsurance transaction, the District Court looked to the communications exchanged between the parties to determine the nature of the actual agreement between them. The court saw that from 1989 through to 1993 none of the documents exchanged between the parties, the submissions, requests, binders, facultative notes and certificates contained any reference to EPI. The court pointed out that the reinsurers agreed to reinsure the peril of earthquake and consequential business interruption, and they followed all of the Warnaco Policy's terms and conditions with respect to the business interruption coverage pursuant to the "following form" clauses. However, EPI was not a term or condition of the business interruption coverage contained within the Warnaco Policy, but rather a separate and distinct endorsement to that.

In this respect it was also questioned whether the Wellington Agreement⁵⁰⁷ altered the reinsurance policies and whether the follow the settlements doctrine binds reinsurers by an agreement which was entered into after reinsurance was issued. In *North River v. CIGNA*⁵⁰⁸ the Court held that "follow the fortunes" doctrine does not require the reinsurer to cover risks undertaken after the certificate of reinsurance is issued, and the reinsurer is not liable for coverage occasioned only because of the Wellington Agreement. The Wellington Agreement represented an innovative effort by asbestos producers and their insurers to solve the asbestos litigation crisis. The Agreement established a non-profit claims handling centre that coordinated claim payments on behalf of producers. It also contained provisions that aimed to avoid coverage disputes between producers and their insurers and established arbitration procedures to adjudicate claims the participants could not settle. Wellington did not rewrite existing policies between producers and their insurers. Rather, the Agreement aimed to avoid coverage disputes by applying insurance arrangements "in a consistent manner."

10.4 Overriding effect of the follow the form clauses

It is sometimes seen that reinsurers may be exposed to liability beyond the cover that they in fact agreed. In *Imperial Fire Ins. Co. of London v. Home Ins. Co. of New Orleans*⁵⁰⁹ Royal and Imperial reinsured Home under a treaty which allowed Home to accept future

⁵⁰⁷ For the Wellington Agreement see above fn 272.

⁵⁰⁸ 52 F 3d 1194 CA 3 (NJ), 1995.

⁵⁰⁹ 68 F 698 CA5 1895.

risks which would then be declared to the treaty. Home warranted to retain \$25,000 and the subject matter was “cotton subject to coinsurance clause”. A coinsurance clause is one which provides that if the assured is not insured for the full value of the subject matter then the assured and insurers share the loss proportionately⁵¹⁰.

Some of the policies issued by Home did not contain the coinsurance clause, so that Home was liable for greater sums than would otherwise have been the case, and that affected the reinsurers. The reinsurance policy was written “subject to the same risks, conditions, and valuations, indorsements, etc., that are or may be assumed or accepted by the original insurer.” The majority held that the reinsuring clause overrode the obligation of Home to insure only on a coinsurance basis, in that the reinsurers had agreed to follow the liability of Home and failure to disclose that some policies did not contain the coinsurance clause was not a material fact.

The majority view was that reinsurance was a contract of liability insurance, and that the liability was unaffected by a failure by the reinsured to insert a coinsurance clause. But it may be thought obvious that the object of the coinsurance clause was to reduce the reinsured’s liability. As the dissenting judge said the majority decision permitted the reinsured to recover from the reinsurer sums for which the reinsured never asked, for which it never paid, and upon risks never insured by the reinsurer, and which the reinsured agreed that the reinsurer should not insure.

⁵¹⁰ For example if the cotton is worth \$100,000 and is insured for only \$50,000 and if cotton to the value of \$10,000 is destroyed, the insurer and the assured share the loss \$5000 each because they are co-insurers. If there is no coinsurance clause then the insurers will pay the full \$10,000, and indeed they will pay the full amount of any loss up to policy limit of \$50,000 – it is only where the loss exceeds the policy limit of \$50,000 that the assured has to bear any part of the loss himself.

11.1 No "Follow the Fortunes" clause

In the absence of a follow the fortunes/settlements clause it is a settled rule that the reinsured must prove its liability in the same way that the assured has to prove its loss to the reinsured, and the reinsurer is entitled to rely upon any defence that might be available to the reinsured in a suit upon the original policy⁵¹¹. Where a reinsured's liability is established by a judgment, it is accepted that reinsurers are bound by such a decision so long as this risk is also within the reinsurance policy cover⁵¹². The courts are normally reluctant to recognise or enforce a judgment against a person who was not party to the dispute but a judgment in an action between an assured and reinsured is regarded as an exception to the rule that a judgment does not affect a non-party, given the interest of reinsurers in the outcome⁵¹³.

The reinsured may choose to settle the claim with their assured without litigating the latter's claim. In one of the earliest reinsurance cases in the US, *Hastie v De Peyster*,⁵¹⁴ it was emphasised that reinsurance policies normally contain an express clause where the reinsured is entitled to make a claim by only proving the payment of the loss, and in this case in admitting or contesting the claim the reinsured's only obligation is to act in good faith⁵¹⁵. The court regarded this as a special contract between the reinsured and the reinsurer and held that in the absence of an agreement as to follow the settlements of the reinsured, the reinsured is obliged to prove the existence and extent of the loss in the same manner as if he was the original insured. When he has done that, the reinsured is entitled to make its claim against the reinsurer⁵¹⁶. That view is retained by the modern reinsurance

⁵¹¹ *New York State Marine Ins. Co. v Protection Ins. Co.* 18 F Cas 160 (CC Mass 1841).

⁵¹² *Strong v. Phoenix Ins. Co.* 62 Mo 289, 1876.

⁵¹³ *North River Ins. Co. v. CIGNA Reinsurance Co.* 52 F 3d 1194 CA 3 (NJ), 1995. The Third Circuit noted that they found no difference between the effects of court judgments and arbitration decisions for "follow the fortunes" purposes.

⁵¹⁴ 3 Caines, 190 (1805).

⁵¹⁵ In the early reinsurance cases the courts looked for assistance from English law, but as reinsurance was rendered unlawful in England by the statute of the 19 Geo. II., no assistance was available from English authorities. However, it was emphasised that reinsurance was lawful in France and the French authorities indicated that as a general principle reinsurance and original insurance are independent of each other and the reinsurer has no responsibilities against the assured and the clauses which entitles the reinsured to make claims against the reinsurer upon proof of payment where the reinsured acted in good faith was in use. See also *New York v Protection*.

⁵¹⁶ In *Hastie v De Peyster* the policy did not provide a follow the fortunes clause. Hastie and Patrick were the hull insurers of the vessel "Sally", owned by the assured, Warren, for the sum of \$1000. In the course of

authorities⁵¹⁷: in *National American Ins. Co. of California v. Certain Underwriters at Lloyd's London*⁵¹⁸ the Ninth Circuit accepted this “accurately portrays the common law rule in California”⁵¹⁹.

11.2 Settlement Clauses

As a general principle reinsurers are not obliged to make any payments to reinsureds where there was no basis for liability to the assured, namely, where the reinsured has made a payment which it in fact was not bound as a matter of law to make. However, the parties may specify in the reinsurance contract that a settlement or other adjustment of loss between the assured and the reinsured is to be binding on the reinsurers. By so doing the reinsurer's obligation to indemnify the reinsured becomes dependent on the reinsurance policy terms, and not on the question of whether the insured suffered a loss as a matter of law under the original policy⁵²⁰.

11.2.1 Distinguishing “Follow the Fortunes” from “Follow the Settlements”

Settlement clauses in the US are called “follow the fortunes” or “follow the settlements” provisions, a typical formulation of which will read, “All claims involving this reinsurance, when settled by the company, shall be binding on the reinsurer.”⁵²¹ There is no common view as to whether or not the follow the fortunes clause serves any different function than the follow the settlements clause. It is not clear whether or not follow the fortunes is narrower than follow the settlements. Some cases suggest that it is wider than

a voyage from Malaga to NY the vessel was captured and taken to Santa Domingo. The assured sought to abandon the vessel to the insurers on the ground that there had been constructive total loss, but the insurers refused to accept the abandonment. However, it was agreed between the assured and the insurers that when the vessel reached NY the assured was entitled to sell the vessel and dispose of her on the most favourable possible terms, and that he would still be entitled to make his claim for constructive total loss against the underwriters and if he succeeded he could claim the policy moneys but deduct from the policy moneys the amount he received from the sale. All of this happened. The assured sold the vessel, and then successfully made a claim against the insurers. They were found to be liable for \$832.35 under the policy and that sum – minus the amount received by the assured for the sale of the vessel – was paid to the assured. The reinsurers were held to be liable for: (a) the sums paid by the insurers; (b) the assured's legal costs of \$108.53; and (c) the insurers' legal costs of \$30.56.

⁵¹⁷ *Michigan Tp Participating Plan v. Federal Ins. Co.*, 233 Mich App 422, 1999 (applying Michigan law). See also *Royal Ins. Co. of Liverpool, England, v. Caledonian Ins. Co. of Edinburgh, Scotland* 182 Cal 219, 1920 (*dictum*); *Pacific Mut. Life Ins. Co. v. Pacific Sur. Co.*, 69 Cal App 730, 734, (1924) (also *dictum*).

⁵¹⁸ 93 F 3d 529 CA 9 (Cal), 1996.

⁵¹⁹ However the court noted that they did not accept the reinsurers' contention that this rule precludes evidence of custom and usage to the contrary to the effect that a settlement clause may be implied into reinsurance contracts if custom and usage permits to do so. The Ninth Circuit noted that where, as here, the law derives from the common law but not statute, the rule that custom or usage cannot overcome a rule of law applies with less force. See below, implication of follow the fortunes clause.

⁵²⁰ *Michigan Tp v. Federal*.

⁵²¹ *State Auto. Mut. Ins. Co. v. American Re-Insurance Co.* 748 F Supp 556, SD Ohio, 1990.

follow the settlements⁵²² while others indicate that follow the fortunes is narrower⁵²³. The difference between these two clauses is stated to be that follow the fortunes is implied into every reinsurance contract whereas, follow the settlements is not and while the former more properly relates to the obligation of a reinsurer to follow developments affecting the reinsured's business that are outside its control, follow the settlements refers to the claims handling function of the reinsured, namely, that the clause prevents a reinsurer from second guessing bona fide claim settlements that are made in good faith⁵²⁴. Follow the fortunes has also been defined as requiring reinsurers to accept a reinsured's good faith decision that a particular loss is covered by the terms of the underlying policy, while the "follow the settlements" doctrine requires reinsurers to abide by a reinsured's good faith decision to settle, rather than litigate, claims on that policy⁵²⁵.

It has been stated that, during the early history of reinsurance, underwriters agreed to contribute to profits or losses of traders as they conducted their business around the world⁵²⁶. This seems to be the source of the follow the "fortunes" clause, given that such an agreement requires the reinsurer to contribute to the reinsured's bad or good fortunes⁵²⁷. In today's reinsurance, if the clause is to be distinguished from the follow the settlements clause, it may be said that the word "fortunes" is more suited to treaties than to facultative reinsurance. In treaties, reinsurers allow the reinsured to exercise a large measure of their own discretion and therefore "fortunes", in the sense of "course of good or bad luck... in some undertaking" can be seen to refer to the obligation of reinsurers to that of the reinsured⁵²⁸. The insurer may be required to make claims payments, subject to the terms and limitations of the reinsurance agreement, in connection with a policy although he is not obliged to do so in objective terms (eg in cases of fraudulent action on the part of the insured which cannot be proved). The "follow-the-fortunes" clause is therefore designed to protect the reinsured against circumstances beyond its control⁵²⁹. On

⁵²² *North River Ins. Co. v. Ace American Reinsurance Co.* 361 F 3d 134 CA 2 (NY), 2004.

⁵²³ *Holland v Employers Reins. Corp.*, 2007 US Dist Lexis 68069 (WD Okla).

⁵²⁴ *The Law of Reinsurance Claims 1997 Supplement* of Blatt, Hammesfahr & Eaton (supplement by Robert W Hammesfahr, Scott W Wright), 64.

⁵²⁵ *Commercial Union Ins. Co. v. Seven Provinces Ins. Co.* 9 F Supp 2d 49 D Mass., 1998 aff'd 217 F 3d 33 CA 1 (Mass), 2000.

⁵²⁶ Langen, JF, "Special Clauses and Endorsements", *Reinsurance Contract Wording*, 3rd Ed, Ed by R.W.Strain, 1998, 582.

⁵²⁷ Langen, 582.

⁵²⁸ Staring, para 18:1.

⁵²⁹ Gerathewohl, K, *Reinsurance Principles and Practice*, Vol I, 1980, 711, 712; Holmes, E M/Sutin, A S Original Edition by Appleman, J A, *Holmes' Appleman On Insurance 2D* (as modified by the Cumulative Supplement, 2007), Vol. 14, Law of Reinsurance, LexisNexis Publishing 2000 § 106.2.

the other hand, follow the settlements pertains to the obligations of the reinsured for particular amounts voluntarily paid out in settlement of specific claims on behalf of the underlying insured⁵³⁰. Despite the conflicting analysis, it is clear from modern precedent that the word “fortune” in fact is used not to follow the reinsured’s fortune where there was no settlement clause but rather it is now interchangeably used with the follow the settlements clause⁵³¹.

11.2.2 Functions of Settlement Clauses

The condition that the reinsured is obliged to prove a loss under the reinsurance agreement in the same way as the assured must prove a loss under the direct policy was held to be unnecessary where the reinsurance policy contained a clause that the reinsurance was “...subject to the same risks, valuations, conditions and mode of settlement as are or may be adopted or assumed by said company”,⁵³².

The follow the settlements doctrine requires payment where the reinsured’s good faith settlement is at least arguably within the scope of the insurance coverage that was reinsured even if technically not covered by it⁵³³. In other words, where a reinsurer agrees to follow the fortunes of the reinsured, the question is not whether the underlying claim was covered by the reinsured’s policy, but whether there is any reasonable basis to conclude there was such coverage⁵³⁴. Therefore, reinsurers are not entitled to second guess the reinsured’s good faith judgments as for settling the claim with the assured, or the reinsured’s good faith decision to waive defences to which it may be entitled⁵³⁵. In

⁵³⁰ *Holmes’ Appleman* § 106.2.

⁵³¹ *Affiliated F.M. Ins. Co. v. Employers Reinsurance Co.* 369 F Supp 2d 217 DRI, 2005; *Houston Cas.Co. v Lexington Ins. Co.*, 2006 US Dist LEXIS 45027; *Stonewall Ins. Co. v. Argonaut Ins. Co.* 75 F Supp 2d 893, N.D.Ill.,1999 (applying California law). Vitkowsky, VJ, “The Central Arena: Follow The Fortunes vs. Utmost Good Faith”, Mealey’s Litigation Report: Reinsurance, May 22, 1996, Vol 7, #2, 30; Cuff, J, “Follow the Fortunes:Industry Customs And Practices”, Mealey’s Litigation Report: Reinsurance, June 15, 2000, Vol 11 #3, 31; Nepl, D J, “Reinsurance Coverage for “Annualized” Loss Presentations Under Multi-Year Policies: “Follow the Fortunes” or Bellefonte?”, Coverage (Published by Lexis Nexis), Vol 16, Number 3, May/June 2006.

⁵³² *Consolidated Real Estate & Fire Ins. Co. v. Cashow* 41 Md 59, 1874.

⁵³³ *Christiania General Ins. Corp. of New York v. Great American Ins. Co.* 979 F 2d 268 CA 2 (NY), 1992; *American Employers’ Ins. Co. v. Swiss Reinsurance America Corp.* 275 F Supp 2d 29 D Mass., 2003, aff’d 413 F 3d 129 CA 1(Mass), 2005; *Travelers Cas. and Sur. Co. v. Ace American Reinsurance Co.* 392 F Supp 2d 659 SDNY, 2005 (applying New York law); *Granite State Ins. Co. v. ACE American Reinsurance Co.* 849 NYS 2d 201 NYAD 1 Dept, 2007; *Commercial Union v. Swiss Reinsurance; Aetna Cas. & Sur. Co. v. DR Ins. Co.* 1995 WL 46640 SDNY; *National Union Fire Ins. Co. of Pittsburgh, PA v. American Re-Ins. Co.* 441 F Supp 2d 646 SDNY, 2006.

⁵³⁴ *North River v. CIGNA* 52 F 3d 1194 CA 3 (NJ), 1995.

⁵³⁵ *Holland v Employers; Houston v Lexington; Hartford Acc. & Indem. v. Columbia Cas. Co.* 98 F Supp 2d 251 D Conn, 2000; *ReliaStar Life Ins. Co. v. IOA Re, Inc.* 303 F 3d 874 CA 8 (Minn), 2002 (applying

*International Surplus Lines Ins. Co. v. Certain Underwriters and Underwriting Syndicates at Lloyd's of London*⁵³⁶ this standard was said to be purposefully low for the reason that if reinsurers are entitled to interfere with the reinsured's decision-making process, the foundation of the reinsured-reinsurer relationship would be damaged because a reinsured faced with de novo review of its claims determinations would ultimately feel the need to litigate every coverage issue rather than settling the claim. In this case, Owens-Corning purchased several layers of liability insurance. The first layer, an umbrella policy, provided coverage in each of the four years of cover in the amount of \$25 million for each "occurrence." The sum recoverable was subject to a \$1 million deductible for "each and every occurrence." Having been exposed to massive number of asbestos claims, the assured made a claim against its insurer by taking the position that the asbestos claims against it arose from one occurrence – its decision to manufacture and sell products containing asbestos. ISLIC, the reinsured, accepted this analysis and the assured paid ISLIC on the basis that there was only one \$1 million "per occurrence" deductible in each of the four annual policy periods. In the subsequent dispute between the reinsurer and ISLIC, the court rejected the reinsurers' assertion that each asbestos claim by each individual claimant had to be treated as a separate occurrence, subject to a separate \$1 million deductible. According to the court, by reason of the follow the fortunes doctrine⁵³⁷ the reinsurer is obliged to follow the reinsured's settlements where it acted in good faith in settling the claim. After having examined the state of the law concerning the number of occurrences, the court found that the focus had to be on "the underlying circumstances which resulted in the claim for damages" rather than on the number of persons injured or the items damaged; therefore the assured's and, in turn the reinsured's settlement was reasonable under Ohio law. The court recognised that the application of multiple deductibles would create virtually no coverage, and any interpretation of the term "occurrence" as a per claim term would render the umbrella policies meaningless. The court found that Owens-Corning's position was influenced by this fact, and it was not unreasonable for ISLIC to accept that the term referred to a single "occurrence."

Minnesota law); *Stonewall v. Argonaut*; *City of Renton v. Lexington Ins. Co. (USA)* 2007 WL 2751356 WD Wash; *Travelers Cas. and Sur. Co. v. Constitution Reinsurance Corp.* 2004 WL 2387313, ED Mich; *Mentor Ins. Co. (U.K.) Ltd. v. Brannkasse* 996 F 2d 506 CA 2 (NY),1993; *Royal v. Caledonian*.

⁵³⁶ 868 F Supp 917 SD Ohio, 1994.

⁵³⁷ It looks like the court implied the follow the fortunes doctrine because the court applied the doctrine even though they stated that the "reinsurance contracts provide that the reinsurers will indemnify ISLIC against all loss, damage or liability after such loss is proved".

Encouraging settlements has also been stated to be a matter of public policy. In *Insurance Co. of State of Pennsylvania v. Associated Intern. Ins. Co.*⁵³⁸ the settlement agreement between the insurers, ICP, and the assured, Fibreboard, called for the payment of “future unidentified claims”. The reinsurers asserted that they were liable only for payments which were “actually expended to injured claimants by way of settlement or judgment.” The Ninth Circuit stated that the settlement agreement required ICP to pay asbestos claims “as and if such claims arise.” Pursuant to the reinsurance contract, Associated’s liability “shall follow that of [ICP] and shall be subject in all respects to all the terms and conditions of the [ICP-Fibreboard] policy....” Under the ICP-Fibreboard policy, ICP was required “to indemnify [Fibreboard] for all sums which [Fibreboard] shall be obligated to pay by reason of the liability....” Therefore, since the asbestos claims represented a liability against Fibreboard which it was obliged to pay, ICP had to indemnify Fibreboard and, pursuant to the reinsurance contract, Associated was required to indemnify ICP. The Ninth Circuit found that accepting the reinsurers’ argument would be contrary to the policy in question and would frustrate the public policy of encouraging settlement.

As previously commented, in the US reinsurance disputes are mostly arbitrated. It was suggested that even though courts have recognised limits on the scope of the “follow the fortunes” doctrines, the reinsurance industry largely measures mutual relationships as if a particular contract included a broad follow the settlements clause⁵³⁹. It should be noted that it is the case that most arbitration panels pay attention to provisions in reinsurance contracts directing them to consider reinsurance agreements as “honorable engagements”⁵⁴⁰.

11.3 Exception to the follow the fortunes clauses

11.3.1 Fraud or bad faith

It is undisputed that the reinsurers may not object to the reinsured’s settlement of a claim unless the settlement was fraudulent, collusive or made in bad faith⁵⁴¹.

⁵³⁸ 922 F 2d 516 CA 9 (Cal), 1990 (applying California Law).

⁵³⁹ *New Appleman Guide*, 40.19.

⁵⁴⁰ *New Appleman Guide*, 40.19, 40.24: An honourable engagement clause instruct arbitrators to interpret the contract “as an honourable engagement and not merely as a legal obligation” and relieves arbitrators from following the strict rules of law.

⁵⁴¹ *Christiania v Great American* 979 F 2d 268 CA 2 (NY), 1992; *Hartford v. Columbia* 98 F Supp 2d 251 D Conn, 2000; *North River v CIGNA* 52 F 3d 1194 CA 3 (NJ), 1995; *American Bankers Ins. Co. of Florida v. Northwestern Nat. Ins. Co.* 198 F 3d 1332 CA 11 (Fla), 1999; *Granite v ACE*; *Pacific v. Pacific*;

The burden of showing bad faith is on the reinsurers⁵⁴², and it is not easily discharged: the reinsurer must show that the reinsured had been guilty of deliberate deception, gross negligence or recklessness, or that the settlement was not even arguably within the scope of the reinsurance coverage⁵⁴³. To equate bad faith with simple negligence would lead virtually every decision by the reinsured to be second-guessed and litigated under a simple negligence standard which would eventually vitiate all of the policy reasons that gave rise to the follow the fortunes doctrine⁵⁴⁴. Accordingly, the question is not whether the reinsured was ultimately correct or incorrect, but whether it acted in good faith at the time⁵⁴⁵.

In *Granite State Ins. Co. v. ACE American Reinsurance Co.*⁵⁴⁶ ACE American Reinsurance Company agreed to reinsure excess umbrella liability policies issued by the subsidiaries of American International Group (collectively known as AIG). ACE reinsured only one of the policies that AIG insured which was issued by Granite State (GS) in 1979. Castle & Cooke (C&C), the assured, was exposed to thousands of claims by field workers who claimed injuries as a result of being exposed to the pesticide dibromochloropropane (DBCP). After having consulted with its counsel AIG argued that the GS policy did not provide coverage for C&C's claim. C&C then entered into a future cost agreement (FCA) with certain AIG companies as to which policies would provide defence and indemnity on the C&C claims on an ongoing basis. AIG realised that it paid more than the available limits with respect to defence expense and indemnity on one of its National Union (NU) policies issued to C&C which was not reinsured by ACE. Then AIG and C&C added an addendum to the FCA that AIG had exhausted the applicable limits of its NU policy and, "to the extent and any sums remain unpaid, they shall become the responsibility of Granite State." AIG made claim against the reinsurer by alleging that C&C faced with 26,000 lawsuits in many states and foreign countries and once the NU policy was exhausted, the FCA was amended by endorsement to replace the policy with the GS policy. However, AIG did not clarify how it moved around its losses in order to charge ACE to the GS policy.

Insurance Co. of State of New York v. Associated Mfgs' Mut. Fire Ins. Corp. 74 NYS 1038, aff'd 174 NY 541, 1903.

⁵⁴² *Houston v Lexington* 2006 US Dist LEXIS 45027.

⁵⁴³ *North River v CIGNA* 52 F 3d 1194 CA 3 (NJ), 1995; *Hartford v. Columbia* 98 F Supp 2d 251 D Conn, 2000; *ReliaStar v. IOA Re* 303 F 3d 874 CA 8 (Minn), 2002; *Travelers Cas. & Sur. Co. v. Gerling Global Reinsurance Corp. of America* 419 F 3d 181 CA 2 (Conn), 2005.

⁵⁴⁴ *American v. Northwestern* 198 F 3d 1332 CA11 (Fla), 1999.

⁵⁴⁵ *American v Northwestern* 198 F 3d 1332 CA11 (Fla), 1999.

⁵⁴⁶ 849 NYS 2d 201 NYAD 1 Dept, 2007.

The Appellate Court took into consideration that the GS excluded DBCP claims, the FCA did not mention GS in the parties that was stated in the list and AIG allocated the loss fell within the GS policy after discovering that it made payments under the NU policy. Noting that where there is concurrency of coverage between the original insurance and reinsurance policy, the follow the fortunes doctrine imposes a contractual obligation upon reinsurer to indemnify the reinsured for payments it makes pursuant to a loss settlement under its own policy, the reinsurer was held not to oblige to follow settlements that made in bad faith or with the knowledge that the payment was outside the original policy. The court concluded that AIG's claim fell within the exception of bad faith and ex gratia payments to follow the fortunes doctrine.

Another example of a finding that the reinsured had acted in bad faith is *City of Renton v. Lexington Ins. Co. (USA)*⁵⁴⁷ where the reinsured paid a claim without further notice to, or consultation with, the reinsurers, knowing that the reinsurers had already declined to cover the claim under the "inherent vice" exclusion.

11.3.2 Reinsurance Policy Defences

11.3.2.1 Claim clearly outside the scope of original insurance

A reinsurer is not obliged to indemnify the reinsured where the latter's claim is clearly beyond the scope of the original policy⁵⁴⁸. In *Independence Ins. Co. v. Republic Nat. Life Ins. Co.*⁵⁴⁹ a life insurance policy lapsed before the assured died by reason of unpaid monthly instalment of premiums. Nevertheless the reinsured paid under the policy and claimed to be indemnified by the reinsurers. The Court of Civil Appeals of Texas held that a contract of reinsurance did not either enlarge the rights of the insured under the original policy or renew rights already lost. If the reinsured was not liable under the terms of the original contract of insurance issued by it to the assured then, by the same token, the reinsurers could not be liable. The Court also stated that, by a follow the fortunes clause, the reinsurer submitted itself to any settlement or adjustment of liability on the original policy which the reinsured might adopt or assume in good faith, but such authorisation did not mean the reinsured could impose liability on the reinsurer by settlement or adjustment of a claim for which no liability existed as a matter of law.

⁵⁴⁷ 2007 WL 2751356 WD Wash.

⁵⁴⁸ *Aetna v. DR Ins; North River v CIGNA* 52 F 3d 1194 CA 3 (NJ), 1995.

⁵⁴⁹ 447 SW 2d 462 Tex Civ App, 1969.

Similarly, in *Insurance Co. of North America v. U.S. Fire Ins. Co.*⁵⁵⁰ the goods which were insured while in transit from US gulf ports to the United Kingdom were destroyed by hurricane while undergoing bagging operations at Gulfport. The reinsurance policy provided “...to pay as may be paid by the Reassured, liable or not liable”. The reinsured paid the assured and, relying on especially the phrase “liable or not liable” in the reinsurance contract, contended that the reinsurer was liable whenever the reinsured decided, unilaterally, to pay its assured. The Court rejected this argument and held that the reinsured’s construction would be an unwarranted and indeed tortured construction of that clause, in that it held a reinsurer bound, for example, to pay if the primary insurer paid monies to its insured on a claim completely without the scope of the policy and not in good faith. Referring to an English case *Western Assurance Co. of Toronto v. Poole*⁵⁵¹ the court stated that the “follow the fortunes” clause was certainly a broad one, and that it was clear that the reinsurer was liable only for “a loss of the kind reinsured”. To determine what type of loss was reinsured, the court turned to the original insurance contract. Subsequent to the issuance of the reinsurance policy, the reinsured issued two binders to the assured, for an additional premium, providing coverage for inland transport “from Int. U.S. to Gulfport, Miss., and while at risk there at State Authority Warehouse, Gulfport, Miss. during bagging operations and thence until laden on board overseas vessel.” The court found that issuance of the two binders indicated the reinsured’s intention that the original insurance contract was not intended to cover the losses occurring during bagging. The stoppage and bagging of the cargo at Gulfport was an interruption in the transit of the goods and created a shore risk not insured and the reinsurers never consented to reinsure a loss not covered in the original insurance policy.

11.3.2.2 Claim Beyond the Reinsurance Policy Cover

While a “follow the fortunes” clause limits a reinsurer’s defences, it does not make a reinsurer liable for risks beyond those agreed in the reinsurance certificate⁵⁵². In other words, the clause does not create reinsurance cover where none otherwise existed⁵⁵³.

⁵⁵⁰ 322 NYS 2d 520 NY Sup 1971, aff’d by 348 NYS 2d 122 NYAD 1 Dept 1973.

⁵⁵¹ [1903] 1 KB 376.

⁵⁵² *North River v. CIGNA* 52 F 3d 1194 CA 3 (NJ), 1995; *City of Renton v. Lexington; American Ins. Co. v. North American Co.* 697 F 2d 79 CA(2) 1982; *Fireman’s Fund Insurance Company v Aachen & Munich Fire Insurance Company* 2 Cal App 690, 1906; *Central Nat. Ins. Co. of Omaha v. Prudential Reinsurance Co.* 241 Cal Rptr 773, 1987. The Supreme Court ordered that the opinion be not officially published.

⁵⁵³ *Affiliated F.M. Ins. Co. v. Employers Reinsurance Co.* 369 F Supp 2d 217 DRI, 2005. *North River v CIGNA* 52 F 3d 1194 CA 3 (NJ), 1995.

In *Michigan Millers Mut. Ins. Co. v. North American Reinsurance Corp.*⁵⁵⁴ an excess layer reinsured paid the assured's claim under an umbrella policy even though the claim was within the deductible to be borne by the assured. Dealing with the claim against the reinsurer the Court of Appeals of Michigan stated that the extent of the liability of the reinsurer was determined by the language of the reinsurance contract, and the reinsurer could not be held liable beyond the terms of its contract merely because the original insurer had made payment. If no liability had attached to the insurer under the original contract, there could be no recovery against the reinsurer, for nothing existed upon which to base an indemnity. Holding the reinsurer liable in this case would effectively have required the court to rewrite the policy. The reinsured contended that although it contributed to a settlement that was less than the assured's retention, it agreed to do so in order to avoid exposure to a potentially larger jury verdict and excessive litigation costs. However the Court stated that interpreting the contract in this way would expose the reinsurers to greater risk than contracted for, and it rejected the reinsured's public policy argument.

Reinsurers plainly do not have to pay any amount beyond the limits of liability stated in the reinsurance policy⁵⁵⁵. In *Bellefonte Reinsurance Co. v. Aetna Cas. and Sur. Co.*⁵⁵⁶ the reinsured settled a claim with the assured, covering also the assured's defence expenses even though the aggregate payment was in excess of the cap stated in the policies. The reinsurance agreement provided "All claims involving this reinsurance, when settled by the Company, shall be binding on the Reinsurer, which shall be bound to pay its proportion of such settlements, and in addition thereto, in the ratio that the Reinsurer's loss payment bears to the Company's gross loss payment, its proportion of expenses ... incurred by the Company in the investigation and settlement of claims or suits...."

The reinsured claimed the settled amount from the reinsurer by contending that the follow the fortunes clause obliged the reinsurer to follow its settlement. The Second Circuit declined to read the "follow the fortunes" clause as negating the phrase "the reinsurer does hereby reinsure Aetna ... *subject to the ... amount of liability set forth herein.*" This was so because such an interpretation would strip the limitation clause and other conditions of all meaning; the reinsurer would be obliged to reimburse the insurer for any and all funds

⁵⁵⁴ 182 Mich App 410, 1990.

⁵⁵⁵ *American Marine Ins. Group v. Neptunia Ins. Co.* 775 F Supp 703 SDNY, 1991.

⁵⁵⁶ 903 F 2d 910 CA2 (NY), 1990.

paid. The court stated that the follow the fortunes clause “coexist[s] with, rather than supplant[s], the liability cap”. The phrase “in addition thereto,” was also challenged by Aetna but the court stated that the function of the phrase in the clause was merely to differentiate the obligations for losses and for expenses; it was not designed to exempt defence costs from the overall monetary limitation in the certificate⁵⁵⁷. Rather, the court held that defence costs were “subject to” the express cap on liability in each certificate. Accordingly, this monetary limitation was a cap on all payments under the certificate. It did not indicate that either component was not within the overall limitation⁵⁵⁸.

The same approach was followed by the Michigan District Court in *Travelers Cas. and Sur. Co. v. Constitution Reinsurance Corp.*⁵⁵⁹ Travelers’ policy provided coverage to Dow for the period 1975 to 1978. CRC reinsured Travelers under three reinsurance certificates for the same time period for “\$1,000,000 each occurrence and in the aggregate where applicab[l]e part of \$4,000,000 part of \$8,000,000 part of \$15,000,000 which in turn is excess of \$24,000,000.” The reinsured settled the assured’s claim and then argued that the \$1 million per occurrence limits in the three reinsurance certificates should be annualised, so that the reinsured could obtain reinsurance coverage up to \$3 million for each certificate. The District court noted that the “Reinsurance Accepted” for the 75-78 reinsurance certificate was \$1 million for “each occurrence and in the aggregate where applicab[l]e part of” \$8 million. There was nothing in the express language of the certificates stating that the \$1 million limited apply “annually” or “each year” or “for each annual period.” Rather, they unambiguously granted coverage up to \$1 million (not \$3 million) for each occurrence during the period of reinsurance coverage. Interpreting “each occurrence” to mean “each occurrence, each year” would require reading in a contract term that was not there. The court also refused to read the follow the form clause as

⁵⁵⁷ It was suggested that the limit of liability set forth in the certificate’s declaration page should clearly mention whether that limit is including or excluding expenses. Determining How to “Follow the Fortunes”, Presented by Clifford H. Schoenberg (Miller, Singer, Raives & Brandes, PC) at Safeguarding Your Rights in Reinsurance Agreements, New York, 1991.

⁵⁵⁸ *Bellefonte* was followed by *Unigard Sec. Ins. Co., Inc. v. North River Ins. Co.* 4 F 3d 1049 CA2 (NY), 1993. In *Excess Ins. Co. Ltd. v. Factory Mut. Ins.* 3 NY 3d 577, 2004 the reinsured’s claim for its litigation expenses against the assured was above the reinsurance policy limit. It was held that holding otherwise would make the reinsurer subject to limitless liability, it was particularly unfair where because of the follow the settlements clause the reinsurer has no control over the handling with an unsuccessful litigation against the assured. See also *Argonaut Ins. Co. v. Travelers Ins. Co.* 2005 WL 66778 (NY Sup) Unreported Disposition where it was held that the follow-the-settlements clause does not alter or override the other terms of a reinsurance contract, or obligate a reinsurer to indemnify a reinsured for payments in excess of the reinsurer’s agreed-to exposure.

⁵⁵⁹ 2004 WL 2387313, ED Mich, 2004 (applying Michigan law).

disregarding the reinsurer's liability limit under the reinsurance policy⁵⁶⁰. The policy issued to Dow provided coverage for \$4.5 million part of \$15 million, but reinsurance was only provided for \$1 million part of \$4.5 million. If Travelers were allowed to recover its full liability to Dow simply because it held some amount of reinsurance, the negotiated coverage limits of the reinsurance certificates would be rendered meaningless.

In *Calvert Fire Ins. Co. v. Yosemite Ins. Co.*⁵⁶¹ it can be seen that the rule as for the reinsurance policy defences is strictly interpreted. Yosemite issued liability insurance policy to Yellow Cab Co of California (Yellow Cab) against the liability imposed upon it by law arising out of the operation of its taxi cabs, subject to a self-insured retention or deductible of \$25,000. Calvert reinsured Yosemite for fifty per cent of each loss in excess of \$25,000 up to a limit of 300,000. The problem here arose when Yellow Cab went into bankruptcy and Yosemite became liable under its policy to pay claims within Yellow Cab's self-insured retention of \$25,000. Yosemite thereupon made a demand that its reinsurers, Calvert, paid claims of less than \$25,000 which had been made against Yosemite.

The first provision of the reinsurance contract provided: "...liability of [Calvert] specified in Item 4 shall follow that of the Company, except as otherwise specifically provided herein, and shall be subject in all respects to all the terms and conditions of [Yosemite's] policy". Under item 4 of the reinsurance contract Calvert reinsured Yosemite for the first \$50,000 of its exposure over the Yellow Cab retention for each person injured; \$150,000 for all bodily injuries in any one accident; and \$25,000 for property damage in any one accident. The court found that item 4 was not ambiguous and the first provision had to be construed to mean that the reinsurer's liability followed that of the reinsured within the limits specified in Item 4. To construe the clause otherwise would effectively have eliminated the provision in Item 4 that the reinsurer's liability began after the self-insured retention had been exhausted.

It was also ruled that, unless reinsurers expressly agreed otherwise, they were not liable for the increase of the original insurance limit which was agreed after the reinsurance

⁵⁶⁰ The District court expressed that the clause expressly limits the reinsurance to the terms and conditions of the underlying policy and provides that the reinsurance certificate will cover only the kinds of liability covered in the original policy issued to the insured.

⁵⁶¹ 573 F Supp 27 DCNC, 1983 (applying North Carolina law).

policy had incepted. In *Penn Re, Inc. v. Aetna Cas. and Sur. Co.*⁵⁶² the court noted that the follow-the-fortunes doctrine did not support the proposition that Aetna could unilaterally increase the reinsurers' liability by agreeing with the assured to do so.

11.4 Scope of the Follow the Settlements Clauses

11.4.1 Claiming the defence costs of the assured's claim

11.4.1.1 No follow the settlements clause

In a very early reinsurance case, it was held that upon notification of the assured's claim, if the reinsurer declined to indemnify the reinsured, thereby forcing the reinsured to incur costs to defend the assured's claim, it was perfectly reasonable to hold the reinsurer liable for the defence costs incurred by the reinsured, on the basis that the reinsurers could have prevented the reinsured from incurring those costs by affirming the claim⁵⁶³. This reasoning was applied in *New York State Marine Ins. Co. v Protection Ins. Co.*⁵⁶⁴ where it was emphasised that, upon notification of the assured's claim, if the reinsurer did not use the opportunity to contest that claim or to authorise the reinsured to compromise or settle the claim, the reinsurer was deemed to have consented to the defence of the claim and thereby impliedly to have agreed to indemnify the reinsured against the costs and expenses necessarily and reasonably incurred in defending the suit⁵⁶⁵.

It is also stated in *New York v Protection* that the reinsured's ability to claim "a full indemnity for the entire loss sustained by him, and also for the costs and expenses, which he has reasonably and necessarily incurred, in order to protect himself" is subject to the requirements that:

- the assured's action is just and reasonable
- the conduct of the insurer is bona fide
- the insurer exercised a sound discretion

⁵⁶² 1987 WL 909519 EDNC.

⁵⁶³ *Hastie v De Pesyter* 3 Caines, 190 (1805).

⁵⁶⁴ 18 F Cas 160 (CC Mass 1841).

⁵⁶⁵ In *Faneuil Hall Ins. Co. v. Liverpool & London & Globe Ins. Co.* 153 Mass 63, 1891, in an action upon a policy of reinsurance to recover, besides the insurance money, the expense of an unsuccessful defence of a suit, of which the reinsurer had notice, and of the successful defence of another suit, of which the reinsurer had no notice, the former alone was held recoverable. See also *Gantt v. American Cent. Ins. Co.* 68 Mo 503, 1878; *New York Bowery Fire Ins. Co. v. New York Fire Ins. Co.* 17 Wend 359, 1837.

Extrinsic evidence as to these requirements was accepted in *TIG Premier Ins. Co. v. Hartford Acc. & Indem. Co.*⁵⁶⁶ where the reinsurance policy provided “Reinsurance Accepted: 150,000 each occurrence/NIL aggregate, being 20% P/O \$750,000 each occurrence/NIL aggregate, excess item 5.” The reinsured offered evidence that in 1994 the reinsurer paid the reinsured for a claim under a nearly identical reinsurance policy and, reimbursed the reinsured for legal expenses in addition to the dollar amount set forth in the “Reinsurance accepted” box. The reinsured also offered the reinsurer’s own internal documents concerning the policy before the court, in which a claims analysis conducted for the reinsurer stated that [e]xpenses are in addition to limits ... [t]he policy limits under such policies are not eroded by defense expenses”. Two experts, who worked in the reinsurance industry in the 1970’s, the period when this policy was entered into, also stated that it was “standard practice within the industry” for reinsurers to pay their pro-rata share of the primary insurer’s payments of the underlying insured’s liability damages and also the same percentage of the primary insured’s reimbursement of the underlying insured’s defence costs. The court found that the evidence was more than sufficient to prove that the “Reinsurance Accepted” meant that “the reinsurer’s coverage included not only 20% of the reinsured’s obligations to Dow on the \$750,000 reinsured liability risk but also 20% of the related defence costs incurred or covered by the reinsured under its primary policy.” The court noted that a New York court might not interpret the clause this way but a California court would recognise this interpretation of the clause in the light of extrinsic evidence.

In the US, reinsurance policies usually contain a clause regarding the reinsurer’s liability for expenses incurred by the reinsured. For example in *Employers Ins. Co. of Wausau v. American Reinsurance Co.*⁵⁶⁷ the court found that the clause “all expenses incurred in the investigation and settlement of claims or suits” covered expenses incurred in declaratory judgment actions where the reinsured contested the assured’s claim⁵⁶⁸.

⁵⁶⁶ 35 F Supp 2d 348 SDNY, 1999 (applying California law).

⁵⁶⁷ 256 F Supp 2d 923 WD Wis, 2003.

⁵⁶⁸ For a comment on the case see Kendall W. Harrison, “Recent Developments Concerning A Reinsurer’s Obligation To Pay Its Reinsured’s Declaratory Judgment Expenses”, *Mealey’s Litigation Report*, Vol.14, #5, July 3, 2003, 24.

11.4.1.2 Follow the settlements clause

It may be argued that where a reinsured has paid for the assured's defence costs in an amount which, together with the amount of the assured's liability, exceeds the original policy limits, the reinsurers are liable to indemnify the reinsured for the defence costs even though they are in excess of the reinsurers' own limit of liability. The assertion is based on the argument that such liability arises because the scope of reinsurance cover is identical to the cover provided by the original policy. In *Aetna Cas. and Sur. Co. v. Home Ins. Co.*⁵⁶⁹ Aetna put forward this contention even though the ultimate net loss clause in Aetna's outwards excess policies expressly excluded⁵⁷⁰ liability for the costs of defending claims against the assured. The policy provided a standard follow the form clause. The court also recognised that the follow the fortunes doctrine was to be implied into all reinsurance contracts including the present contract. It was held that concurrency of coverage between the original policy and the policy of reinsurance was provided by the follow the form clause and, according to the follow the settlements doctrine the reinsurer was under a contractual obligation to indemnify the reinsured for payments it made pursuant to a loss settlement under its own policy, provided that such settlement was not fraudulent, collusive or otherwise made in bad faith, and provided further that the settlement was not ex gratia. The reinsurer was held to be not liable for the defence costs incurred by the assured because such costs were outside the original insurance cover and therefore not covered by the reinsurance policy⁵⁷¹.

In *Aetna Cas. & Sur. Co. v. Philadelphia Reinsurance Corp.*⁵⁷² the first clause of the reinsurance policy stated "[Phil Re] [d]oes hereby reinsure Aetna ... subject to the terms, conditions and amount of liability set forth herein, as follows." The amount of Phil Re's liability was stated to be \$7.5 million. The reinsurance policy provided a follow the form clause and a follow the fortunes clause whereby the reinsurer's loss payment was to bear to the reinsured's gross loss payment its proportion of expenses, other than reinsured

⁵⁶⁹ 882 F Supp 1328, SDNY, 1995.

⁵⁷⁰ In *Aetna v Home* the court provided for definitions that "A policy that includes no duty to defend the insured and no provision for the payment of defense costs by the insurer is referred to as 'cost-exclusive' "; the insured must bear the costs for investigating and defending against such claims. "A policy that provides for a duty to defend subject to an overall limit of liability is 'cost-inclusive' "; the maximum liability of the insurer to its insured is capped by the limit of liability expressed in the policy. "Where the policy places in the insurer a duty to defend the insured but does not by its terms include those costs within the limit of liability such a policy may be termed 'cost-supplemental' ".

⁵⁷¹ Home provided reinsurance cover from 1970 through 1976 and the reinsurer was held to be liable for claims under 1970 policy year only because in 1970 policy year, unlike other years that were covered, defence costs were unambiguously included within insurance company's definition of ultimate net loss.

⁵⁷² 1995 WL 217631 ED Pa (applying Pennsylvania law).

salaries and office expenses, incurred by the reinsured in the investigation and settlement of claims or suits. Applying *Bellefonte*⁵⁷³ the District court judge held that the reinsurer's entire obligation was quantitatively limited by the dollar amount the reinsurers agreed to reinsure. Once the reinsurers had paid up to the certificate limits, they had no additional liability to Aetna for defence expenses or settlement contributions. Any other construction of the reinsurance certificates would negate the first clause stated above⁵⁷⁴.

Regardless of whether the policies are cost-inclusive or not, it is accepted that a reinsured's declaratory judgment expenses are not a "risk" that is reinsured by the reinsurer. In *British Intern. Ins. Co. Ltd. v. Seguros La Republica, S.A.*⁵⁷⁵ the reinsurance policy provided: "...subject to the same risks, valuations, conditions, endorsements (except changes of location), assignments and adjustments as are or may be assumed, made or adopted by the reinsured, and loss, if any, hereunder is payable pro rata with the reinsured and at the same time and place...". BIIC, the reinsured, argued that the then-prevailing custom in the industry required the reinsurer to pay a pro rata share of the reinsured's expenses in resisting coverage; and that such payment was compelled by the reinsurance doctrine requiring the reinsurer to follow the fortunes of the reinsured. The Second Circuit rejected this argument for the reason that the follow the fortunes doctrine simply required payment where the reinsured's good-faith payment to its insured was at least arguably within the scope of the insurance coverage that was reinsured. According to the court BIIC's contention required proof that its own declaratory judgment expenses in litigating against its policyholders were potentially within the coverage of the underlying policies. However the court was of the view that this could not be done because the policyholders obtained no benefit from the mounting of coverage litigation against their own claims; such an initiative could be conceived as any part of the policyholders' coverage; on the whole, any policyholder would prefer the insurer to forgo the contest. The reinsurers did

⁵⁷³ 903 F 2d 910 CA2 (NY), 1990.

⁵⁷⁴ One day after the court granted the summary judgment for the reinsurer, the Third Circuit decided *North River v. CIGNA* and Aetna applied for reconsideration of the Pennsylvania District Court decision in favour of the reinsurer for the reason that *North River v. CIGNA* effected a change in the law mandating a denial of Phil Re's motion. Aetna argued that it was held in *North River* that whether the underlying insurance policies are cost-inclusive or cost-supplemental is the dispositive factor in interpreting a follow the fortunes clause. The District Court stated that in *Bellefonte* the reinsurance policy was cost-inclusive. The court stated that the issue in *North River* was whether the certificates covered costs at all, ie whether they were cost-exclusive, not whether they were cost-inclusive or cost-supplemental. *North River* did not reach the issue decided here and in *Bellefonte*, it did not affect a change in the law warranting denial of Phil Re's summary judgment motion. Aetna's motion for reconsideration was denied.

⁵⁷⁵ 342 F 3d 78 CA 2 (NY), 2003 (applying New York law).

not by their contract agree to cover the claims-handling expenses that an insurance company incurs in the conduct of its own operations.

The Second Circuit also noted that the trade usage must establish either that the party alleged to be bound was aware of the custom, or that the custom's existence was "so notorious" that it should have been aware of it. Moreover the trade usage must have been "so well settled, so uniformly acted upon, and so long continued as to raise a fair presumption that it was known to both contracting parties and that they contracted in reference thereto." Thus, the reinsured must prove that the reinsurer either actually knew of the alleged custom, or that the practice of reinsurers' paying declaratory judgment expenses was so notorious in the industry that the reinsurer must have been aware of it⁵⁷⁶.

In *Penn Re v. Aetna*⁵⁷⁷ the court refused to apply the follow the fortunes doctrine to claims for the assured's defence costs that the reinsured had agreed to pay. However, in this case the reinsurer was held to be obliged to pay such a claim because of the wording of the settlement clause. Despite the reinsurer's objection Aetna settled the claim with its assured, Robins, agreeing to pay an amount substantially in excess of its original policy limits. The reinsurance policy provided that "All claims involving this reinsurance, when settled by the Company, shall be binding on the Reinsurer, which shall be bound to pay its proportion of such settlements, ... the Reinsurer's limit of liability bears to the Company's gross limit of liability with respect to business accepted on a pro rata basis and, with the prior consent of the Reinsurer to trial court proceedings, its proportion of court costs and interest on any judgment or award." This clause, according to the court, provided that as to all claims involving the reinsurance policies, when settled by Aetna, the settlement thereof was binding on the reinsurers and they were thereby bound to pay their proportion of such settlements. It addressed the reinsurers' obligation for "costs" incurred in settling claims brought by a third person alleging to have been injured by an assureds' product covered by the reinsurance certificate. The court held that this provision was not limited to Aetna's liability for the risks which the underlying insurance policies covered, but requires that, in addition, Aetna was liable for its proportion of the expenses incurred by Penn Re. The court also noted that in settling with Robins, Aetna amended the limits of its excess policies upwards and the follow the fortunes doctrine could not make the reinsurers liable

⁵⁷⁶ According to the Second Circuit, the practice of one company would not be sufficient to establish a trade usage.

⁵⁷⁷ Not Reported in F Supp, WL 909519 EDNC, 1987.

for the newly increased limits unless the reinsurers had agreed to be so bound. The reinsurers were held to be liable for the settlements including defence costs because of the abovementioned clause, not because they follow the fortunes doctrine.

Remarkably, in *North River v. CIGNA* the absence of an express exclusion of defence costs in the reinsurance contract was held to be based on a holding that the reinsurers were liable for such costs. In this case under procedures established by the Wellington Agreement an arbitrator ruled that North River Insurance Company was obliged to pay defence costs, in excess of policy limits, to its insured. The reinsurer agreed to be bound by all settlements by North River and also accepted liability for its proportion of expenses incurred by North River in the investigation and settlement of claims or suits and, with its prior consent to trial court proceedings, its proportion of court costs and interest on any judgment or award. The reinsurers, however, argued that they were not liable for the defence costs because they were not covered by the original policy. In the original insurance policy while paragraph 13 excluded all “Costs”, paragraph 15 provided that costs incurred by Owens-Corning “with the written consent of [North River]” would be apportioned. The Second Circuit adopted the arbitrator’s interpretation that these apparent inconsistencies provided a limited exclusion for costs that excluded expenses incurred unreasonably. The Second Circuit also noted that reading the consent clause as meaning that North River could only be liable for defence costs associated with litigation or a settlement to which it had given its formal consent would be inconsistent with paragraph 11 of the policy, which provided that North River’s obligation to pay costs was not attach until the underlying limits had been paid. According to the Court, compliance with both paragraphs was in practice not feasible. Consequently it was held that the coverage of defence costs was within the terms of the North River-Owens-Corning insurance policies and the reinsurer was bound to follow the settlements in the absence of proof of fraud or bad faith of the reinsured. The Second Circuit also noted that the reinsurer could have avoided liability for defence costs if it had expressly excluded such coverage in the reinsurance certificates it issued to North River. On the contrary, the North River reinsurance certificates expressly referred to the reinsurer’s obligation to reimburse for “court costs and interest on any judgment or award” arising out of consented-to litigation.

11.4.2 Extra Contractual Obligations

Extra Contractual Obligations (ECO) are defined in the US as “damages awarded by a court against an insurer or reinsurer that are outside the provisions of the insurance policy, due to the insurer’s bad faith, fraud, or gross negligence in the handling of a claim”⁵⁷⁸.

It has come before the courts that whether or not the follow the fortunes clause applies to punitive damages awarded against an assured or a reinsured. The opinions are not unanimous and depending on the facts or the case and the policy wording. In principle unless the parties expressly agree⁵⁷⁹, the clause does not apply punitive damages because the clause applies to the claims at least arguably within the original policy cover whereas ECO, by definition, arises outside the reinsurance policy⁵⁸⁰.

This view was applied in *American v. North American*⁵⁸¹ where the jury had awarded punitive damages against the assured for deliberate corporate misbehaviour. The reinsured nevertheless settled the claim most of which covered such an excluded loss from the original insurance and reinsurance policy. The court rejected the reinsured’s argument that follow the fortunes clause required the reinsurers to indemnify the reinsured for punitive damages.

However, as will be seen below, the cases suggest that agreeing to follow the fortunes of the reinsured may include to follow the fortunes as for extra contractual obligations depending on the policy wording and also the particular facts of the case⁵⁸². For instance in *Inland Mut. Ins. Co. v. Peerless Ins. Co.*⁵⁸³ the reinsurers were held to be liable for the reinsured’s share of extra contractual obligations in the absence of any express clause. Inland issued a vehicle liability policy under which Inland agreed to indemnify the assured against liability for personal injuries arising out of the operation of the insured’s vehicles to the extent of \$15,000 for injuries arising to one person in any one accident. Pursuant to the reinsurance treaty, Inland retained \$5,000 of this coverage and transferred to Peerless

⁵⁷⁸ Glossary of Insurance and Risk Management Terms, 11th, IRMI Book Collection, 2007, 104.

⁵⁷⁹ *Hartford Fire Ins. Co v Lloyd’s Syndicate* 1997 US Dist LEXIS 10858 (DConn 1997) it was accepted that the clause “those liabilities . . . which arise from the handling of any claim [including] but not limited to . . . alleged or actual negligence, fraud or bad faith. . . .” included ECO.

⁵⁸⁰ *Curiale v. DR Ins. Co.* 593 NYS 2d 157 NY Sup, 1992. Schoenberg (conference paper); Staring, §18:7.

⁵⁸¹ 697 F 2d 79 CA 2 (NY), 1982.

⁵⁸² Hollenbach, M, “Surplus Share”, Reinsurance Contract Wording, 3rd Ed, Ed by R W Strain, 1998, 201.

⁵⁸³ 152 F Supp 506, aff’d, 251 F 2d 696 CA4 1958.

the excess, forwarding to Peerless the appropriate proportion of the premium paid by the assured.

The assured was involved in an accident where a third party made a claim against him. The reinsured and reinsurer were notified the claim. During the litigation the claimant's advocate offered a settlement of \$20,000 but the advocate representing the assured and appointed by the reinsured without objection by the reinsurer found the amount too high considering the claim, and was of the opinion that they should not settle for more than \$7,500. The claimant rejected this offer, and after a trial the jury awarded \$75,000, Inland paid the assured \$15,000, and Peerless paid Inland \$10,000. Then, the assured brought an action against Inland for its negligence and bad faith in failing to settle the third party litigation for \$17,500. The parties reached a settlement where Inland paid the assured \$27,500, and the assured paid the third party this \$27,500 together with an additional \$30,000 (the face amount of the policy together with \$15,000 contributed by the assured), or a total of \$57,500, for the release of the third party judgment of \$75,000. Afterward the reinsured initially claimed the full \$27,500 which later was reduced to two-thirds of that amount. Inland also claimed from Peerless its "proportionate share" of the expenses of investigating and defending the Arms-Yeatts (third party – assured) suit and the Yeatts-Inland (assured-reinsured) suit.

The court put emphasis on the fact that Inland kept Peerless fully and adequately informed of the significant developments in the case of *Arms v. Yeatts*. Peerless expressed no objection to the nature or quality of the defence provided by Inland. The court⁵⁸⁴ noted that under the original policy the obligation of Inland was to defend any suit against Yeatts, and it had the right to investigate, negotiate and settle any claim or suit, and as the liability of Peerless followed that of Inland in every case, upon actual payment of loss by Inland, the question was whether or not the payment by Inland of \$27,500 and expenses in the *Yeatts v. Inland* suit, was a loss or expense of Inland under its policy insuring Yeatts.

⁵⁸⁴ There is no previous authority on the matter, so the court has to decide the question for itself without the benefit of earlier judicial guidance. Therefore the court stated that the question that whether Peerless is liable under the facts in this suit is one of first impression.

The court also found that law firm defending the third party claim was selected by Inland, but Peerless never at any time objected, nor did seek to exercise its rights to be associated with the Company in the defence or control of any claim or suit or proceeding by appointment of its own counsel⁵⁸⁵.

Peerless therefore was held to know as much about the Arms case as did Inland and Peerless was freely and frankly consulted by Inland, and Peerless left the decision in Inland's hands, that decision became the decision of Peerless as well as Inland; Peerless was accordingly bound along with Inland by that decision whether sound or unsound, favorable or unfavorable; and that because the liability of Peerless "shall follow that of" Inland, Peerless was liable for two-thirds of the cost to Inland of a concededly proper settlement of the Yeatts-Inland litigation. Notably, the court accepted in this case that claims cooperation created a joint enterprise: in other words, in defending the action against Yeatts, the companies were unquestionably engaged in a joint enterprise, the losses arising from which were to be borne in accordance with their respective interests in the enterprise.

It has been suggested that the interpretation of the contract language and defining the parties as joint venturers was wrong⁵⁸⁶: the court ignored the fact that the reinsurer agreed to follow the reinsured's liability under the original policy, not outside it. Once the reinsured's liability under the original policy was exhausted, no further liability could to be imposed on the reinsurer. It has also been said that it was the reinsured who could make the ultimate decision despite the reinsurer's involvement in investigating and defending the claim⁵⁸⁷. The reinsurer did not have control of the handling of the underlying claim and should not be penalised by that⁵⁸⁸. The author found that in *Peerless* the insurer were penalised by the court for having analysed both the original claim and the nature of the reinsurance relationship accurately⁵⁸⁹. It should be noted that *Peerless* did not rule on what the position may be where the reinsurer is not fully

⁵⁸⁵ In fact, Peerless appointed its Assistant Secretary (an attorney) who extensively involved in the handling of the claim.

⁵⁸⁶ Schoenberg, C H, "Follow The Fortunes And Extra Contractual Obligations ("ECOs")", Mealey's Litigation Report: Reinsurance, July 8, 1992, Vol 3 #5 p.24.

⁵⁸⁷ Schoenberg, 25.

⁵⁸⁸ Schoenberg, 25.

⁵⁸⁹ Schoenberg, 25.

appraised of all developments regarding the claim or was not consulted about the settlement procedure within the policy limits or where the reinsurer refused to settle the claim after the consultancy.

Peerless has since been regarded as a case that is confined to its facts⁵⁹⁰ and was distinguished in *Employers Reinsurance Corp. v. American Fidelity & Cas. Co.*⁵⁹¹ where the extra-contractual liability of the reinsured concerned an excess of loss reinsurance which did not contain a follow the fortunes clause. In *Employers*, the Court emphasised that in *Peerless* the court took a limited view because of the follow the fortunes clause and the excess liability claim resulting from the particular dealings between the parties. The District court also rejected the joint enterprise argument and stated that the instant reinsurance contracts could not be construed as creating a joint adventurer relationship between the reinsured and the reinsurer.

A commentator has suggested that ECO are to be distinguished from Excess of Loss Policy Limits (XPL) which relate to *covered losses* that are in excess of the policy limits⁵⁹². Similar to the view adopted in *North River v CIGNA* as for the defence costs above, it was contended that where a reinsurance agreement contains a follow the fortunes clause, so long as the reinsured acted in good faith in settling the claim, the strict ECO rules should not be applicable and the reinsurer should be bound by the settlement unless the reinsurance policy expressly provides to the contrary⁵⁹³. The author justifies this approach by arguing that holding otherwise might cause claims decisions to be distorted, thereby ultimately increasing the losses claimed from reinsurers⁵⁹⁴. It is not clear what the author means by saying “unless specifically agreed otherwise” but if he was referring to the situation in which XPL was not expressly excluded then the author is effectively saying that as long as the reinsured has acted in good faith in settling the claim, the reinsurer should follow its settlement irrespective of the maximum sum reinsured. In *Bellefonte*, which was decided two years before the article was published, it had been decided that the follow the fortunes clause could not be interpreted so as to

⁵⁹⁰ See *Bellefonte*.

⁵⁹¹ 196 F Supp 553 DC Mo 1959.

⁵⁹² Maneval, A, “ “Follow The Fortunes” And Excess Of Policy Limit Obligations”, Mealey’s Litigation Report: Reinsurance, September 9, 1992, Vol 3 #9, 15.

⁵⁹³ Maneval, 18.

⁵⁹⁴ Maneval, 17.

disregard the reinsurance policy limits. There is no reason why the reinsurer should be obliged to pay more than the policy limit simply to prevent a reinsured distorting the claim⁵⁹⁵. And in fact as the Second Circuit noted in *Unigard*⁵⁹⁶ a reinsurance policy provides otherwise for the policy limits.

11.5 Implying settlement clauses

The rationale of the settlement clauses is accepted to be to meet the goal of maximising coverage, reducing relitigation by simplifying the reimbursement process and preventing a reinsurer from continually challenging the propriety of a reinsured's settlement decisions⁵⁹⁷. The latter consideration in particular has led the courts to consider implying the follow the fortunes clause into all reinsurance contracts where the wording itself is silent.

It is accepted by some of the decisions that it is commonly understood that reinsurers must "follow the fortunes" of their insured; therefore, even if this is not expressed in the reinsurance agreement, the doctrine nevertheless is applicable⁵⁹⁸. In *National American v. Certain Underwriters*⁵⁹⁹ the Ninth Circuit stated that the necessity for reinsured to establish the loss in the same way as must the assured in order to recover upon the original policy, derives from the common law but not statute and under circumstances as such the rule that "custom or usage cannot overcome rule of law" applied with less force. The court commented that cases such as *Royal v. Caledonian*⁶⁰⁰ suggest only that the reinsurer does not have to follow the settlement in the absence of an agreement to the contrary, but they do not preclude evidence of custom or usage to the contrary. The court held, however, that the existence of custom or usage is a factual question, so that trial was necessary on this issue.

⁵⁹⁵ That is true that in *Penn Re v Aetna* Not Reported in F Supp, WL 909519 EDNC, 1987 the reinsurer was held liable beyond the policy limit but the ratio of the case did not base on the follow the fortunes doctrine but a particular clause that the court relied on.

⁵⁹⁶ 4 F 3d 1049 CA2 (NY), 1993.

⁵⁹⁷ *Travelers v. Constitution; Carlson Holdings Inc. v. NAFCO Ins. Co.* 205 F Supp 2d 1069 DMinn, 2001 (applying Minnesota law).

⁵⁹⁸ *ISLIC; Aetna v. Home Ins.* 882 F Supp 1328, SDNY, 1995; *American v. Swiss.*

⁵⁹⁹ 93 F 3d 529 CA9 (Cal), 1996.

⁶⁰⁰ 182 Cal 219, 1920.

A similar interpretation to that of *North River v CIGNA* can be seen in *ReliaStar v. IOA*⁶⁰¹ in terms of implication of a settlement clause. In *ReliaStar* it was held that the contracts, which did not contain “anti-follow-the-fortunes” provisions, should not be interpreted as preventing the implication of the customary follow-the-fortunes clause into the retrocession. The reinsurance contract between Canada Life and ReliaStar referred to the ETFS Travel Health Medical Reinsurance Agreement, which required strict proof of coverage for the claim reinsured. The retrocession placement slips stated: “Conditions: See attached ETFS Travel Health Medical Reinsurance Agreement”. The Eighth Circuit rejected the retrocessionaire’s contention that the slip incorporated the terms of the reinsurance contract, including the clause requiring strict proof of liability, and held that the plain purpose of these slips was to identify the parties to the retrocession agreement, the period of coverage, and the coverage that the retrocessionaire was to provide, among other details, but not to incorporate a set of specific procedures agreed to between Canada Life and ReliaStar in a separate agreement to which neither of the retrocessionaires were a party. The loss settlement procedures of the underlying insurance policy did not form part of the operative terms of the retrocessional contracts at issue.

It has been argued that decisions such as those in *National American*, *ISLIC* and *Aetna* come into play where the reinsurance contract does not require the reinsured to seek the reinsurer’s approval in settling the claim and the claim is not excluded by the terms of the reinsurance contract⁶⁰². However, the majority opinion of the courts suggests that the parties to a reinsurance contract are sophisticated enough to write their own policy wordings to protect their respective interests by negotiation of the terms of the reinsurance agreement⁶⁰³. Imposing liability on the reinsurer for a settlement contribution absent such an agreement would be to write a new contract for the parties⁶⁰⁴. In *Employer Reins. Corp. v. Laurier Indemnity Co.*⁶⁰⁵ the reinsured argued that the contract’s silence as to follow the fortunes created an ambiguity; therefore the Court should allow custom to imply the clause into the reinsurance contract. Accepting that there were certainly benefits and numerous public policy considerations supporting enforcement of the “follow the fortunes” doctrine in the world of reinsurance, the Court nevertheless rejected the

⁶⁰¹ 303 F 3d 874 CA8 (Minn), 2002 (applying Minnesota law).

⁶⁰² Lasley, L M, “Follow The Settlements: Reasonable, Not ‘Deviant’ ”, Mealey’s Litigation Report: Reinsurance, September 27, 1995, Vol 6 #10, 16.

⁶⁰³ *Holland v Employers Reins. Corp.*, 2007 US Dist Lexis 68069 (WD Okla Sept 13, 2007)

⁶⁰⁴ *Michigan Tp. Participating Plan v. Federal Ins. Co.* 233 Mich App 422, 1999 (applying Michigan law).

⁶⁰⁵ 2007 WL 1831775 (MD Fla).

reinsured's argument, for the reason that the parties were both sophisticated entities dealing at arm's length, and familiar with drafting contracts who could agree on a follow the fortunes clause at the outset. The same view was adopted in *American Motorists Ins. Co. v. American Reins. Co.*⁶⁰⁶ where, relying on *Pacific Mutual*, the reinsured argued that even though the reinsurance agreement did not provide express follow the settlements provision, the other language in the policy was sufficient to constitute an agreement to follow the settlements⁶⁰⁷. However the judge found that the clause in *Pacific Mutual* that read "The 'Pacific Mutual' alone shall settle all claims and such settlements shall be binding on the 'Reinsurance Company' in proportion to its participation, whether the settlement be in full or in compromise" was itself an express "follow the settlements" provision. The judge also stated that the reinsured did not present any evidence of "custom and practice" as to the implication of the clause in the reinsurance industry. It was also stated that if the "follow the settlements" doctrine was so widely accepted as an inherent part of every reinsurance contract that the doctrine may be read into every certificate as a matter of law, there would be no need to include such clauses in reinsurance contracts to hold otherwise would be to write a new contract for the parties, which the court had no right to do⁶⁰⁸.

As for other issues regarding the doctrine, while a State court may refer to other jurisdictions, the implication of the doctrine was said to vary depending on which State's laws apply to the contract dispute. In *North River Ins. Co. v. Employers Reinsurance Corp.*⁶⁰⁹ where the issue was to be resolved under New Jersey law, the court noted that *ISLIC* and *Aetna*, the precedents that the reinsured relied on, did not require the application of New Jersey laws of contract interpretation.

11.6 Post-settlement Allocations

Allocation relates to whether and in what manner the reinsurance contract covers a claim by a reinsured⁶¹⁰. Allocation of loss is particularly important when long-tail toxic and environmental claims are in question. When reinsurance comes into play in such claims,

⁶⁰⁶ 2007 WL 1557848 (ND Cal).

⁶⁰⁷ However the claimant did not refer to any specific clause in the reinsurance agreement.

⁶⁰⁸ *Affiliated F.M. Ins. Co. v. Employers Reinsurance Co.* 369 F Supp 2d 217 DRI, 2005; *Michigan Tp. Participating Plan v. Federal Ins. Co.*

⁶⁰⁹ 197 F Supp 2d 972 SD Ohio, 2002 (applying New Jersey law). The Court rejected to apply *ISLIC*.

⁶¹⁰ Robert M Hall and Matthew T Wulf, "Allocation To Reinsurers And Follow The Settlements", Mealey's Litigation Report: Reinsurance, Vol.13, #19, February 6, 2003, 30.

inevitably complications arise as to allocating the loss among reinsurance policies. Reinsureds may settle insured and uninsured claims in a global settlement agreement or there may be more than one reinsurer who has reinsured long-tail risks and which losses will fall upon which reinsurers makes the problem more complicated.

It may be seen that in the US reinsureds sometimes use different loss allocation methods in settling the claim with the assured and making claim against their reinsurers. The standard that the courts look for is whether the allocation is grossly negligent, recklessly done or if the reinsured has acted fraudulently⁶¹¹. If the answer is negative, the reinsurer is unlikely to be able to question the allocation.

11.6.1 Inconsistency between pre-settlement and post-settlement allocations

In order to serve the goals of the follow the settlements doctrine, which are to encourage maximum coverage and settlement and to prevent courts from undermining the foundation of the reinsured-reinsurer relationship, as long as the allocation meets the typical follow the settlements requirements reinsurers have been held to be obliged to follow the reinsured's post-settlement allocation even though there was an inconsistency between the pre-settlement and post-settlement allocations. In *North River v. ACE*⁶¹² the insurer's policies covered portions of the second, third, fourth, and fifth excess layers of assured's coverage. With the exception of \$125,000 of coverage in the third excess layer of the 1978-1980 policies, ACE reinsured only portions of the second excess layer policies. After its products liability coverage was exhausted, the assured settled the claim with the insurer, releasing the insurer from liability under all of its policies with the assured for not only asbestos-related claims but also for any future, non-asbestos-related claims. North River allocated 99% of the costs of the settlement to non-product asbestos claims among its reinsurers using the "rising bathtub"⁶¹³ approach, consistent with its view of the policies and the Wellington Agreement. ACE disputed the settlement allocation because North River's pre-settlement analysis of possible litigation outcomes identified risk of loss

⁶¹¹ *American v Northwestern* 198 F 3d 1332 CA11 (Fla), 1999.

⁶¹² 361 F 3d 134 CA2 (NY), 2004.

⁶¹³ The Second Circuit defined the rising bathtub allocation method "is a phrase used to describe a provision of the Wellington Agreement that deals with how asbestos bodily injury losses would be allocated to insurers. That provision calls for asbestos payments to be allocated on the basis of horizontal exhaustion, which means losses are allocated to the lowest layer of coverage first and, like a bathtub, fill from the bottom layer up. Under that approach, a given layer of coverage is not implicated until the layer beneath it is completely exhausted".

in higher layers but North River assigned its entire settlement to ACE's layer of reinsurance (the second layer).

There were number of reasons that the court found that the reinsurers were obliged to follow the reinsured's settlements: In addition to stressing the need to achieve the goals of the follow the settlements doctrine, the Second Circuit was of the view that requiring post-settlement allocation to match pre-settlement analyses would permit a reinsurer, and require the courts, to scrutinise the specific factual information regarding settlement negotiations. This would undermine the certainty that the general application of the doctrine to settlement decisions created. Furthermore, the court noted that applying the follow-the-settlements doctrine to post-settlement allocation decisions did not leave a reinsurer without protection. Reinsureds must make good-faith allocations, and reinsurers also could not be held accountable for any loss not covered by the reinsurance policy.

In *Travelers v Gerling Global*⁶¹⁴, the reinsurer's position was found to be even weaker than that of ACE outlined above. In this case the assured and the reinsured put forward conflicting theories as to the number of occurrences represented by thousands of asbestos claims arising from hundreds of sites over nearly thirty years of policies. At the arbitration stage the issue as to the number of occurrences was not resolved, and OCF and Travelers settled even though they "explicitly disclaimed any particular theory of coverage" and they never reached agreement as to whether the claims arose from a single occurrence or multiple occurrences. Travelers later allocated the settlements amount evenly among policy years (the "rising bathtub" methodology); because each year's primary policy had a \$1 million per occurrence limit, the primary policies were quickly exhausted. The remaining amount was then spread among the excess policies, including those issued by Gerling. Gerling's contention was that the allocation should have been on the basis of separate occurrences at each site with the result that the loss would not have penetrated the excess⁶¹⁵.

⁶¹⁴ 419 F 3d 181 CA2 (Conn), 2005.

⁶¹⁵ Travellers insured OCF for bodily injury and property damage through a series of annual primary policies. For products coverage policies had a \$1 million "aggregate" limit of liability, thus, if claims arising from multiple occurrences triggered products coverage, the most that Travellers had to pay under any single policy was \$1 million. Once the aggregate limit was reached, the policy was exhausted, regardless of any additional occurrences. However if claims arising from multiple occurrences triggered non-products coverage, each occurrence was subject to a \$1 million limit on liability there was no cap on total liability.

The court distinguished Gerling's position from that of ACE's against North River where the reinsured had clearly considered an alternative allocation position, as evidenced by its documents. The court therefore did not hesitate to apply the rule in *North River v ACE* that the follow the fortunes doctrine applies to the post-settlement allocation as long as the allocation met the typical follow the fortunes requirements, ie, is in good faith, reasonable, and the loss falling within the applicable policies⁶¹⁶.

However the application of the follow the fortunes said rationale of maximising the coverage is not limitless. In *Allstate Ins. Co. v. American Home Assur. Co.*⁶¹⁷ the reinsured's post-settlement allocation was contrary to the District Court judgment which ruled that there were seven occurrences at the site. The parties therefore settled the claims on the basis of multiple occurrences at each site but after the settlement, the lead counsel of the reinsured prepared an allocation which treated each site as one occurrence. The reinsurers audited the reinsured's handling of the claims and litigation and discovered that no single occurrence at these sites would have exceeded the \$1 million retention⁶¹⁸. Thus, the reinsurance obligations would not have been triggered, and the reinsurers sought negative declaratory relief. The court found that the reinsured applied the occurrence deductible at the assured's level to minimise the amount of the reinsured's exposure and loss, whereas at the reinsurance level, in the same loss setting, the occurrence deductible was used as sparingly as possible to maximise the reinsured's recovery against the reinsurer; the court defined such an allocation as neither reasonable nor reflective of good faith but disingenuous. Moreover, the follow the fortunes doctrine was not intended to allow an insurer to use a different set of rules at each level. The court defined the reinsured's allegation as a manifest manipulation in total disregard of its obligation to act in good faith. The court confirmed the rule that despite an inconsistency between pre/post settlement allocations the reinsurer is obliged to follow the settlements as long as the allocation meets the typical follow the settlements requirements but here the settlement was found unreasonable because the one-occurrence-per-site allocation of the Windsor

⁶¹⁶ *Travelers v Gerling Global* was applied in *National Union Fire Ins. Co. of Pittsburgh, PA v. American Re-Ins. Co.* 441 F Supp 2d 646 SDNY, 2006 to provide the certainty that the general application of the doctrine to settlement decisions creates.

⁶¹⁷ 837 NYS 2d 138 NYAD 1 Dept, 2007.

⁶¹⁸ American Home issued commercial property insurance policies to United Technologies Corporation (UTC) where the deductible was \$200,000 for "any one occurrence". 22% of the \$5 million excess of \$1 million layer was reinsured under the 1975 policy. When the 1975 certificate expired, 25% of the \$5 million excess of \$1 million was reinsured.

Locks site directly contradicted the District Court ruling as to the number of occurrences at that site.

11.6.2 Distinguishing Settlement From Allocation

It may also be seen that the US courts have not accepted any distinction between a reinsured's settlement from its post-settlement allocation and have held that allocation is binding so long as the settlement has been made in good faith. In *Commercial Union v Seven Provinces*⁶¹⁹ the reinsured (CU) settled a multi-site environmental liability coverage action for a lump sum payment of \$2.2 million, and the assured thereby released CU from all future liability for any environmental claims. CU allocated the settlement payment among all the sites at which it faced liability, each site being treated as a separate loss for reinsurance purpose so that there was a per-site reinsurance retention. The result of the allocation was that CU's settlement payment on account of a semiconductor site was the only site-specific payment to exceed the retention under the reinsurance contracts. The reinsurance policy contained a "follow the settlements clause"; the reinsurers challenged the reinsured's good faith in the "allocation" rather than in the "settlement". The court found this to be "a distinction without a difference" because there it could see no difference between determining which of several policies covered which particular loss among many and the more general decision that the losses were covered by the policies. The court put emphasis on the complex nature of environmental claims, which necessarily involved a number of sites and a range of years over which the exposure could have occurred. Forcing a reinsured into litigation over its good faith judgment as to which policies covered which losses would make it impossible for the reinsured to come to any settlement of such complex claims. According to the court, when several reinsurers are involved, there would be a risk of successive litigation, in which each reinsurer offered an alternative allocation model designed to minimise its own liability. Challenging either a settlement or an allocation would have the same effects, those of undermining the settlement and of fostering litigation.

This reasoning has been criticised as exaggerated,⁶²⁰ for the reason that in fact only a few cases involving follow the settlement clauses give rise to allocation disputes, and the court

⁶¹⁹ 9 F Supp 2d 49 D Mass, 1998 aff'd 217 F 3d 33 CA 1 (Mass), 2000.

⁶²⁰ Graydon S Staring "Following Settlements And Following Allocations", Lexis Nexis Mealey's Litigation Report: Reinsurance, Vol.15, #15 December 2, 2004, 27.

failed to explain why all the reinsurers affected should not be parties in the allocation dispute in order not to increase the number of reinsurance disputes.

Nevertheless, the reinsured's post-settlement allocation was distinguished from the settlement in *Argonaut v. Travelers*⁶²¹ where Witco and Travelers settled a claim for environmental pollution covering approximately 140 separate sites located throughout the US. The settlement released Travelers from all liability under the Primary and Excess Policies. In making the claim against the reinsurers, Travelers allocated the settlement amount on the basis that the environmental pollution claims constituted a "single occurrence." Upon refusal by the reinsurer to accept that allocation, the court held that the damages which arose from environmental pollution at Witco's approximately 140 sites throughout the US could not properly be aggregated into one occurrence because the damage arising at each site resulted from exposure to the particular conditions existing at that site, and not from some "general conditions" that were "substantially the same" at all of the different sites. Travelers' goal in negotiating the Settlement Agreement was concededly to obtain a "global" settlement, which released it from liability in connection with environmental claims relating to all Witco sites. The court noted that here, the reinsurers were contesting Travelers' allocation of the Witco settlement on a single rather than multiple-occurrence basis, and not challenging the settlement⁶²².

The decision was not greeted with sympathy. It has been argued that the court substantially departed from the way in which the other courts analysed the application of follow the settlements to post-settlement allocations⁶²³. Instead, the court should have looked only at the question whether the settlement was in good faith; the factual inquiry that the court did in-depth was described as "de novo" review of the reinsured's decision in settling the assured's claim which was in fact the follow the fortunes doctrine aimed to prevent⁶²⁴. The commentator noted, however, that if the court had analysed if the

⁶²¹ 2005 WL 66778 (NY Sup), 2005 Unreported Disposition.

⁶²² In *Travelers Cas. and Sur. Co. v. Certain Underwriters at Lloyd's of London* (96 NY 2d 583, 2001) the court recognised the same distinction and held that the *American Bankers* and *ISLIC* cases are inapposite because while these cases deal with challenges the reinsureds' decision to settle claims, in this case the reinsurers are not contesting Travelers' settlement but the challenge is to Travelers' allocation of those settlements.

⁶²³ Rubenstein, A M " 'Follow the Settlements' And Allocation: A Review of Recent Developments" Mealey's Litigation Report: Reinsurance, November 5, 2007, Vol 18 #13, 29.

⁶²⁴ Rubenstein, 29.

allocation was made in good faith, rather than analysing the facts in depth, the same result would probably have followed⁶²⁵.

11.6.3 Allocation that alters the definition of insured peril

In *Travelers v. Certain Underwriters*⁶²⁶ Travelers settled two separate pollution coverage disputes with two different assureds⁶²⁷. The activities of the two assureds at numerous sites in the US resulted in a series of separate claims against them, and in settling those claims under its excess policies Travelers treated the losses at each site as separate occurrences. However, in making a claim against the reinsurer, Travelers calculated the settled amount by treating the environmental contamination at the various sites as having a “common origin” or “traceable to the same act, omission, error and/or mistake” and combined all of the sites for each assured into one occurrence per assured. The treatment of each site as a separate “disaster and/or casualty” would not penetrate any of the retention levels imposed by the reinsurance treaties. The court held that, while a follow the fortunes clause in most reinsurance agreements left reinsurers little room to dispute the reinsured’s conduct of the case, such a clause did not alter the terms or override the language of reinsurance policies. To hold that the follow the fortunes clause supplanted the definition of “disaster and/or casualty” in the reinsurance treaties, and thereby allowed Travelers to recover under its single allocation theory, would effectively have negated that phrase⁶²⁸. The practical result of that argument would have been that a reinsurance contract governed by New York law and which contained a “follow the fortunes” clause would bind a reinsurer to indemnify a reinsured whenever it paid a claim, regardless of the contractual language defining the insured peril or the loss.

⁶²⁵ Rubenstein, 30.

⁶²⁶ 96 NY2d 583, 2001. This case was said to have proved that old saying that “hard cases make bad law”. P Jay Wilker, “Travellers v Lloyd’s – Has New York’s Highest Court Made It Harder For Cedents To Settle With Their Insureds?”, Mealeys’s Litigation Report: Reinsurance, Vol.12, #13, November 1.2001, 26.

⁶²⁷ Travellers settled several coverage disputes for environmental injury claims involving decades of commercial activities at numerous and industrial and waste disposal sites with its insureds DuPont (25 separate environmental sites) and Koppers (160 separate sites).

⁶²⁸ *Travellers* applied in *Hartford Acc. and Indem. Co. v. Ace American Reinsurance Co.* 2005 WL 3663930 Conn Super (the law of Connecticut and New York are the same with regard to the issues involved in this motion therefore the court did not decide which of these law particularly applicable to the contract) where the reinsurance treaty had an independent definition of occurrence and the court did not apply follow the fortunes doctrine to negate the reinsurance policy defence. The case was appealed but the follow the fortunes was not disputed on appeal: 284 Conn 744, 2007.

11.6.4 Annualisation

In *American v. Swiss*⁶²⁹ the original policies were multi-year but the reinsurance agreements were annual. After mediating on ten sites, the reinsured and the assured settled a claim with respect to additional twenty seven sites on which the reinsured had no information. There was no indication that the settlement agreement was based on “annualisation” but when making the claim against the reinsurer, the reinsured calculated the claim on an annualised basis. The reinsurer argued that they would be less liable if the allocation was done “site-by-site ... once per-policy basis”. The reinsured contended that there were authorities to the effect that reinsurers were bound by the post-settlement allocation of the reinsured regardless of what the settlement embodied. However the First Circuit noted that it was not prepared to adopt such a rule. The District Court found no basis for the annualisation and moreover found that the reinsured acted in bad faith in settling the claim for the twenty-seven sites in respect of which the reinsured had no information, bad faith which relieved the reinsurer to follow the fortunes of the reinsured. However the First Circuit did not find that the reinsured acted in bad faith, vacated the judgment, remitted the decision for a follow the fortunes analysis and noted that reinsurers were free to challenge the reasonableness and good faith of reinsurer’s decision to settle.

11.6.5 Comment

It is in fact hard to distinguish an allocation from a settlement. It has been argued that the parties to a reinsurance agreement are sophisticated enough to look after their own business relationship; therefore adopting the rationale that the follow the fortunes doctrine aims “to nurture the relationship” between reinsureds and reinsurers, the notion that it is permissible “to maximise reinsureds’ coverage” is inappropriate⁶³⁰. This view is plainly supportable. In practice an allocation cannot easily be separated from the underlying settlement, and if no objection can be taken to the settlement then it is difficult to object to the allocation. If the settlement is in good faith, then in the absence of exceptional circumstances, the allocation is also to be assumed to have been made in good faith. Challenging the allocation would involve challenging the settlement itself, requiring a de novo review of the type which is intended to be precluded by follow the settlement clauses. The *North River v ACE* decision does not, therefore, seem supportable.

⁶²⁹ 413 F 3d 129 CA1 (Mass), 2005. Either New York or Massachusetts law would be applicable to construe the reinsurance contracts. As the application of either Massachusetts or New York law yielded the same result, the court found unnecessary to make a formal choice of law decision.

⁶³⁰ Grais D J, “Follow-The-Settlements And Its Rationale In American Law”, Mealey’s Litigation Report: Reinsurance, October 5, 2007, Vol 18, #11, 13.

In *Affiliated F.M. Ins. Co. v. Employers Reinsurance Co.*⁶³¹ the main issue was whether the loss was within the reinsurance policy cover. In *Affiliated* the reinsured claimed expenses in addition to the settled amount. If the allocation was in good faith, it could be argued that the reinsurers were obliged to indemnify the reinsured; in fact what the reinsured argued was that under the doctrine of follow the settlements, so long as it entered into the settlement in good faith, even if it was not permitted to claim defence costs, it could be reimbursed for payments made to extinguish future liability for defence costs. However, emphasising the fact that the follow the settlements doctrine cannot impose liability on the reinsurer where none otherwise existed, and also the fact that the Reinsurance Certificate explicitly excluded defence costs from the definition of “loss”, the court held that the proper allocation remained a question of fact, thereby precluding summary judgment.

It should be noted that where the settlement is silent as to allocation, and if the reinsurers reserve their rights for judicial determination when making payment, the reinsurers may be able to challenge the allocation. In *Employers Reinsurance Corp. v. Newcap Ins. Co., Ltd.*⁶³² the assured, Providence hospital, obtained both primary and excess insurance coverage; the claimant New Cap provided excess liability coverage to the hospital through an umbrella liability policy for its primary commercial liability insurance (CGL) and Hospital Professional Liability (HPL) coverage. The reinsurers, ERC, reinsured the New Cap policies one hundred percent. Following a claim by a patient, the hospital entered into a settlement for \$7,600,000. Providence’s insurance companies entered into an Interim Funding Agreement to fund the settlement, under which ERC contributed \$6,600,000; the insurance company providing Providence’s primary coverage contributed \$1,000,000. The underlying dispute arose between ERC and New Cap because the settlement agreement was silent on the question of allocation, ie whether the CGL or the HPL provided coverage: this was significant given that the primary policies afforded different limits and if the claim fell in HPL policy the loss would fall within \$10 million primary coverage limit⁶³³. Consequently, the excess umbrella policy for which ERC provided reinsurance would not attach. The reinsured argued that the claim fell within CLG policy and that New

⁶³¹ 369 F Supp 2d 217 DRI, 2005.

⁶³² 209 F Supp 2d 1184 DKan, 2002 (applying Kansas law).

⁶³³ The primary policies afforded limits of \$10 million for HPL coverage and either \$1 million or \$5 million for CGL coverage (there was a disagreement as to the applicable limits).

Cap was obliged to follow its settlement because it was a good faith and reasonable settlement and the doctrine extended to decisions of how to allocate a settlement between different policies. The reinsurers were held not to be obliged to follow the reinsured's settlements, for the reason that the settlement was silent as to the policy within which the claim fell and the reinsurers had expressly reserved their rights to challenge the allocation.

12.1 Late Notice

12.1.1 When a notification duty arises - Reasonableness

Clauses in reinsurance contracts requiring “prompt notice”, notice “as soon as practicable” or “immediate notice” of claims by reinsureds are generally construed to require notice within a reasonable time after the duty to give notice has arisen⁶³⁴. The test to determine when the reinsured’s duty to provide such notice commences is an objective test of reasonableness⁶³⁵. A mere speculation, rumour, or a remote contingency far removed from particular policy in question is not enough to trigger the objective reasonableness standard⁶³⁶. However, by investigating potential claims with due diligence, when a prudent reinsured would believe that its policy may be involved, the notice obligation arises⁶³⁷. Where a reinsurance policy requires notice when it “appears likely” that claim will or “may” involve the policy, this does not require a probability that the policy at issue will be involved but a “reasonable possibility” of such a happening based on objective assessment of information available will be required⁶³⁸. For example in *Liberty Mutual Insurance Co v Gibbs*⁶³⁹ “losses which ‘may’ give rise to a claim” was held to require showing “a reasonable possibility” and not a reasonable likelihood. In this case Liberty issued a general liability policy to Boston Edison and Lloyd’s reinsured 80% of all payments Liberty became obliged to make in excess of \$250,000. Boston Edison was sued for personal injury loss but its attorney, who took over the defence, did not notify the reinsurer until after the jury returned a verdict for the claimants. The First Circuit decided that the controlling date that the reinsured should have given notice was not the date of jury’s verdict; Liberty’s duty to notify the reinsurer arose soon after it started defending the claim.

⁶³⁴ *Christiania General Ins. Corp. of New York v. Great American Ins. Co.* 979 F 2d 268 CA2 (NY), 1992; *Travelers Ins. Co. v. Buffalo Reinsurance Co.* 735 F Supp 492 SDNY, 1990.

⁶³⁵ *Zenith Ins. Co. v. Employers Ins. of Wausau* 141 F 3d 300 CA 7 (Wis), 1998, (applying Wisconsin law); *Centaur Insurance Company v Safety National Casualty Corporation* 1993 WL 434056 (ND Ill).

⁶³⁶ *Christiania v Great American* 979 F 2d 268 CA 2 (NY), 1992.

⁶³⁷ *Christiania v Great American* 979 F 2d 268 CA 2 (NY), 1992.

⁶³⁸ *Christiania v Great American*.

⁶³⁹ 773 F 2d 15 CA1 (Mass), 1985 (applying Massachusetts law).

Liberty Mutual v Gibbs was applied in *Insurance Co. of State of Pennsylvania v. Associated Intern. Ins. Co.*⁶⁴⁰ the clause “notify [Associated] promptly of any occurrence which in [ICP]’s estimate of the value of injuries or damages sought, without regard to liability, might result in judgment in an amount sufficient to involve this certificate of reinsurance”, was found to be analogous to the notice clause in *Liberty v Gibbs* and it was held that the occurrence that presented “reasonable possibility” of resulting in a claim under the reinsurance policy should have been notified⁶⁴¹.

12.1.2 The Nature of Notification Clauses

12.1.2.1 Conditions Precedent

The remedy for a breach of claims notification provision depends on the nature of the clause. As will be seen in the following paragraphs, in some States, if the clause is a condition precedent, the reinsurers are discharged from liability without any requirement of proof of any prejudice resulting from the breach. However, if the clause is not a condition precedent, proof of prejudice would be necessary. It should nevertheless be noted that this is not a generally accepted rule and some decisions still look for prejudice even though the notification clause is classified as a condition precedent.

12.1.2.2 Clauses that do not contain the words “condition precedent”

Sometimes reinsurance policies clearly state that a claims notification clause is a condition precedent⁶⁴². However, in some States, using such terminology is not essential to determine the nature of claims notification clauses. For example in *Fortress Re, Inc. v. Jefferson Ins. Co. of New York*⁶⁴³ the reinsurance policy contained a notice provision which provided “Prompt notice shall be given to the Reinsurer by the Company of any occurrence or accident which appears likely to involve this reinsurance ...”. The Fourth Circuit granted summary judgment for the reinsurers, who claimed that they were not liable to the reinsured following the breach of the claims notification clause even though the clause did not use the words “condition precedent.”

⁶⁴⁰ 922 F 2d 516 CA9 (Cal), 1990 (applying California law).

⁶⁴¹ The court also referred to a Third Circuit case *Trustees of the University of Pennsylvania v Lexington Insurance Co* (815 F 2d 890, 1987) where a clause “the policy required notice whenever the Insured had information from which it might ‘reasonably conclude’ that an occurrence was ‘likely to involve’ the policy” was interpreted that under Pennsylvania law the insured had the obligation to notify whenever reasonable judgment, based on the information available to insured, suggested that the claim was likely to involve insurer.

⁶⁴² *Constitution Reinsurance Corp. v. Stonewall Ins. Co.* 980 F Supp 124 SDNY, 1997.

⁶⁴³ 628 F 2d 860, CA4 (NC), 1980 (applying North Carolina law).

Similarly, in *Keehn v Excess Ins. Co of America*⁶⁴⁴, it was held that under Illinois law, failure of a third party automobile public liability insurer to give notice to the reinsurer of any accident in which reinsurance may probably be involved in compliance with provisions of reinsurance contract would bar recovery by original insurer upon the reinsurance contract, notwithstanding that the contract did not designate provision requiring notice as a condition precedent or contain a declaration of forfeiture for noncompliance⁶⁴⁵.

In *Travelers v. Buffalo*⁶⁴⁶ the District Court judge put emphasis on the effect of the reinsurers' contractual right to associate⁶⁴⁷. Prompt notice was construed to be designed to afford an insurance company the opportunity to participate in the defence of a claim on which it may ultimately be liable. The fact that reinsurers rarely defend the claim in the same manner as original insurers does not make it less important for reinsurers. Therefore, as in the primary insurance context, notice from the primary insurer to its reinsurer was held to be a condition precedent to the reinsurer's liability.

12.1.2.3 Cases that put emphasis on the terminology

In order to construe a clause as a condition precedent, a clear and unambiguous expression by the parties that they show their intention to make the clause condition precedent is required⁶⁴⁸. For example in *National American Ins. Co. of California v Certain Underwriters At Lloyd's London*⁶⁴⁹ the clause "The Company upon knowledge of any occurrence likely to give rise to a claim hereunder shall give immediate written advice thereof to the person(s) or firm named for the purpose in the schedule" was held not to have such a clear expression. The omission of words "condition precedent" was also found significant in *Security Mut. Cas. Co. v. Century Cas. Co.*⁶⁵⁰. However, not only the terminology but also the nature of reinsurance and the particular wording of the whole policy, were also taken into consideration in the decision. The court found it important that the arbitration clause in the contract was expressly stated to be a condition precedent whereas such wording was omitted in the claims notification clause. Such an omission in

⁶⁴⁴ 129 F 2d 503 CA7 1942.

⁶⁴⁵ See also *Highlands Ins. Co. v. Employers' Surplus Lines Ins. Co.* 497 F Supp 169 DC La, 1980.

⁶⁴⁶ 735 F Supp 492 SDNY, 1990.

⁶⁴⁷ A "right to associate" clause gives right the reinsurer to co-operate with the reinsured in settling the assured's claim. See below Heading no 12.3.

⁶⁴⁸ *Pennsylvania v. Associated* 922 F 2d 516 CA 9 (Cal), 1990.

⁶⁴⁹ 93 F 3d 529 CA9 (Cal), 1996.

⁶⁵⁰ 531 F 2d 974 CA Colo 1976.

the notification clause was held to be an indication that the parties did not intend to make the clause a condition precedent. The court also took into consideration that Colorado law did not favour construing ambiguous terms as conditions precedent and also any ambiguity in a reinsurance contract was to be resolved against the reinsurer unless the contract was worded by the original insurer. Consequently, the Tenth Circuit held that the clause was a covenant but not a condition precedent⁶⁵¹.

In *Security* it was emphasised that in reinsurance contracts, investigating the loss and defence of the claim is usually left to the reinsureds. The participation of the reinsurer in defending the assured's claim was not as essential as it is for primary insurers. The court found that the reinsured and reinsurer had the same concerns and benefits and loss from the claim, and that the reinsured had as much reason as the reinsurer to see that the claim was properly investigated and defended; therefore there was little danger of fraud or imposition between the reinsured and the reinsurer. If the reinsurers had proved any loss by the failure of the reinsured to notify a claim, then damages would have been an adequate remedy.

12.1.3 Prejudice

The classification of a claims notification clause is important because most courts find that if the clause is a condition precedent, the reinsurer does not need to prove prejudice in order to be relieved from liability where the reinsured did not comply with the notification clause. However the determinative point is not if the clause is a condition precedent; much depends on the peculiar wording of the clause and the context of the reinsurance policy wording as a whole.

12.1.3.1 Cases not requiring proof of prejudice

It is usually the case that where the claims notification is worded as a condition precedent or where the court interpreted the clause in that way because of the importance of the provision, breach of such a clause would be a bar to recovery from reinsurers and prejudice would be irrelevant. In *Constitution v. Stonewall*⁶⁵² the clause was expressly stated to be a condition precedent. The assured sued the reinsured after the latter denied coverage but then the reinsured paid \$3.25 million in exchange for the assured dropping

⁶⁵¹ According to the Tenth Circuit holding the clause as a covenant rather than a condition would prevent forfeiture.

⁶⁵² 980 F Supp 124 SDNY, 1997.

its suit. The reinsured became aware of the potential claim under the policy as of 6 June 1990 but did not notify the reinsurer until 20 November 1992. The court held that the notice was not promptly given and the condition operated as a complete bar against Stonewall's recovering under the reinsurance policy without proving prejudice.

The same rule was applied in *Liberty Mutual v Gibbs* where the court put emphasis on the fact that even though Liberty was an experienced underwriter, it did not notify Lloyd's of the accident until several weeks after the jury had returned a verdict⁶⁵³.

In *Travelers v. Buffalo*⁶⁵⁴ the notification clause was not expressly stated to be a condition precedent. It was pointed out that the New York rule treats notification clauses as so fundamental that it requires no proof of prejudice in breach of such provisions because such clauses aim to make insurers adequately investigate the underlying facts of a claim while witnesses and facts remain available, for the purpose of defending the insured and maintaining accurate reserve funds. If deprived of this opportunity, the insurer may not be able to investigate the claim adequately and this may lead to fraud⁶⁵⁵.

12.1.3.2 Cases requiring proof of prejudice

By contrast, in other cases it has been accepted that if the reinsurer suffers no prejudice from an unexcused delay in notice, the purpose of the notice clause has not been frustrated and there is no reason to relieve the reinsurer of its contractual obligation⁶⁵⁶. In *Life and Health Ins. Co. of America v. Federal Ins. Co.*⁶⁵⁷ insured was required to notify the reinsurers "as soon as practicably possible" in the event that a suit was initiated against the reinsured for which the reinsurers could ultimately be liable under the terms of the insurance policy. The district court judge applied the settled rule in the insurance context in Pennsylvania to the reinsurance case before him, that an insurer cannot refuse to pay on an otherwise valid claim solely because the insured's notice was out of time, or because the insured breached a notice provision of the insurance contract. The reinsurers bear the burden of showing that the notice was late, and that they were unduly prejudiced by the

⁶⁵³ See also *Highlands v. Employers'* 497 F Supp 169 DC La, 1980.

⁶⁵⁴ 735 F Supp 492 SDNY, 1990.

⁶⁵⁵ See also *Christiania v Great American* 979 F 2d 268 CA 2 (NY), 1992.

⁶⁵⁶ *Central Nat. Ins. Co. of Omaha v. Prudential Reinsurance Co.* 241 Cal Rptr 773 1987. The Supreme Court ordered that the opinion be not officially published therefore cannot be relied on as precedent. See In *California Joint Powers Ins. Authority v. Munich Reinsurance America, Inc.* 2008 WL 1885754 CD Cal.

⁶⁵⁷ 1993 WL 326404 ED Pa.

lateness. The position is the same in California law: for example, in *Pennsylvania v. Associated*⁶⁵⁸ the Ninth Circuit confirmed that the purpose of the notice clause is to “protect the insurance company from being placed in a substantially less favourable position than it would have been if timely notice had been provided”. Because primary insurers will usually provide a proper defence, the likelihood of prejudice from late notice is more remote. Likewise, in *National American v Certain Underwriters*⁶⁵⁹ the Ninth Circuit looked for substantial prejudice. Similarly, New York law states that in the absence of an express provision in the reinsurance contract making prompt notice a condition precedent to reinsurer’s obligations under the contract, the reinsurer will not be relieved of its indemnification obligations because of the reinsured’s failure to provide timely notice, unless it can show prejudice resulting from delay⁶⁶⁰.

In North Carolina prejudice is required even though the clause is a condition precedent. *Fortress Re, Inc. v. Central Nat. Ins. Co. of Omaha*⁶⁶¹ traces the development of the law in North Carolina. The Fourth Circuit stated that claims notification clauses had long been regarded as conditions precedent where prejudice was irrelevant and the bar on recovery was absolute. However, referring to *Great American Insurance Co v C.G. Tate Construction Co. (Tate I)*⁶⁶² where it was held that the failure to give timely notice to the insurer did not relieve the insurer of its obligations unless the delay materially prejudiced the insurer’s ability to investigate and defend, the court stated that the rule in North Carolina has changed in a way that the designation “condition precedent” no longer has this effect and that reinsurers have to prove either: (a) that they have suffered prejudice; or (b) that the reinsured acted in bad faith in failing to comply with the clause. The Fourth Circuit applied *Tate I* even though it was an insurance case. By defining reinsurance as an insurance contract where one having an insurance company as a policyholder the court stated that it could see no reason why a different rule should be applied to reinsurance contracts. The Fourth Circuit also noted that in *Tate I* the Supreme Court of North Carolina overruled the two state cases on which *Fortress v. Jefferson*⁶⁶³ had been based

⁶⁵⁸ 922 F 2d 516 CA 9 (Cal), 1990.

⁶⁵⁹ 93 F 3d 529 CA9 (Cal), 1996.

⁶⁶⁰ *Christiania v. Great American* 979 F 2d 268 CA 2 (NY), 1992; *Unigard v. North River* 4 F 3d 1049 CA2 (NY), 1993.

4 F 3d 1049 CA2 (NY), 1993; *Travelers Ins. Co. v. Central Nat. Ins. Co. of Omaha* 733 F Supp 522 D Conn, 1990 (applying Connecticut law); *Zenith v. Wausau* 141 F 3d 300 CA 7 (Wis), 1998.

⁶⁶¹ 766 F 2d 163 CA4 (NC), 1985 (applying North Carolina law).

⁶⁶² 303 NC 387, 1981.

⁶⁶³ 628 F 2d 860, CA4 (NC), 1980.

and refused to follow *Fortress*, where the Fourth Circuit decided that the notification clause was a condition precedent even though the clause did not use the words “conditions precedent” and the reinsurers were held not liable without requiring proof of any prejudice.

In *British Ins. Co. of Cayman v. Safety Nat. Cas.*⁶⁶⁴ the Third Circuit was of the opinion that even if it is assumed that a reinsurer’s right to associate can be impaired by a late notice from the reinsured, that risk of impairment is not sufficiently serious to justify the prediction that the New Jersey Supreme Court would abandon the prejudice rule.

12.1.3.3 Proof of Prejudice

Proof of prejudice is a question of fact for the jury⁶⁶⁵. Prejudice to the reinsurer depends upon whether the reinsurer would have been in a more favourable position had it received earlier notice⁶⁶⁶. It was clarified in *Associated Intern. Ins. Co. v. Odyssey Reinsurance Corp.*⁶⁶⁷ that the reinsurer will have to prove that “with timely notice, and notwithstanding a denial of coverage or reservation of rights, it would have settled the claim or taken steps that would have reduced or eliminated” the reinsured’s liability.

In California it is also accepted that⁶⁶⁸ a mere possibility of prejudice will not suffice. Being deprived of the opportunity to join and control the underlying claim or being unable to take “evasive action” to protect the reinsurer against the loss is not enough to prove prejudice. The court accepted that being unable to claim a tax deduction is a prejudice but it was necessary to prove what prejudice had actually been caused. Similarly, in *Unigard*⁶⁶⁹ the Second Circuit held that loss of contractual right to associate itself is not enough to prove prejudice without showing economic loss (tangible economic injury). However in Illinois if the reinsurance policy gives the reinsurer right to associate it is likely that failure to give notice will deprive the reinsurer of the ability to use its contractual right and opportunity to associate with the reinsured in defence of the third

⁶⁶⁴ 335 F 3d 205 CA3 (NJ), 2003 (applying New Jersey law).

⁶⁶⁵ *Life and Health v. Federal* 1993 WL 326404 ED Pa.

⁶⁶⁶ *Life and Health v. Federal* 1993 WL 326404 ED Pa.

⁶⁶⁷ Unpublished Disposition, 111 F 3d 137 CA9 (Cal), 1997.

⁶⁶⁸ *Pennsylvania v. Associated* 922 F 2d 516 CA 9 (Cal), 1990.

⁶⁶⁹ 4 F 3d 1049 CA2 (NY), 1993.

party claim against the assured and this deprivation may be held to constitute prejudice without any actual proof that the results of the litigation would have been different⁶⁷⁰.

12.1.3.4 Presumption of Prejudice

It used to be the position under California law that, because both parties are experienced insurance companies, who bargained at arm's length, and the reinsured acquired all of the claims information that the reinsurer lacked, it would be just and equitable to place the burden of proving compliance with the notice clause upon the reinsured⁶⁷¹. If the reinsured was unsuccessful in meeting its burden, a rebuttable presumption of prejudice arose⁶⁷². The reinsured could rebut the presumption by showing lack of prejudice to the reinsurer⁶⁷³.

However, after the decision of *National American v. Certain Underwriters*⁶⁷⁴ California law requires proof of actual and substantial prejudice, ie that it was likely that, with timely notice, and notwithstanding a denial of coverage or reservation of rights, it would have settled the claim for less or taken steps that would have reduced or eliminated the insured's liability.

In *Zenith v. Wausau*⁶⁷⁵ the reinsurance policy required the reinsured to give prompt notice to the reinsurer and also gave right the reinsurer the right to associate to defend the assured's claim. Wausau handled matters on its own and did not notify Zenith the existence of the claim until after the jury had returned a massive verdict against the assured. The Seventh Circuit noted that according to Wis. Stat. § 631.81⁶⁷⁶, where late notices arrive within a year of the time required by the policy, the claim will not be invalidated unless two criteria are met: the insurer was prejudiced by the late notice, and it was "reasonably possible" to give timely notice. The statute, however, does not address situations where notice is given more than one year after the time in which notice is

⁶⁷⁰ *Keehn v Excess; Stuyvesant Ins. Co. v. United Public Ins. Co.* 139 Ind App. 533, 1966.

⁶⁷¹ *Central v. Prudential* 241 Cal Rptr 773 1987.

⁶⁷² *Central v. Prudential* 241 Cal Rptr 773 1987.

⁶⁷³ *Central v. Prudential* 241 Cal Rptr 773 1987.

⁶⁷⁴ 93 F 3d 529 CA9 (Cal), 1996.

⁶⁷⁵ 141 F 3d 300 CA 7 (Wis), 1998.

⁶⁷⁶ Wis. Stat. § 631.81 provides: (1) Timeliness of notice. Provided notice or proof of loss is furnished as soon as reasonably possible and within one year after the time it was required by the policy, failure to furnish such notice or proof within the time required by the policy does not invalidate or reduce a claim unless the insurer is prejudiced thereby and it was reasonably possible to meet the time limit.

required by the policy. The Seventh Circuit noted that, where notice is given more than one year after time required by policy, there is a rebuttable presumption of prejudice and the burden of proof shifts to the assured to prove that the insurer was not prejudiced by the late notice⁶⁷⁷. Consequently, it was held that Wisconsin law requires some kind of proof of prejudice in all cases in which an insurance company receives late notice.

12.1.4 Exception to the prejudice rule: reinsured's bad faith

It was ruled that, where a reinsurer cannot prove prejudice but he proved its reinsured's bad faith in failing to comply with the notification clause, the reinsurer would be discharged from liability⁶⁷⁸. Bad faith is not to be judged by reference to the conduct of a reasonable person. In *Fortress v Omaha*, following *Tate I*, the test of good faith was stated to be a subjective one, namely that "Anyone who knows that he may be at fault or that others have claimed he is at fault and who purposefully and knowingly fails to notify ought not to recover even if no prejudice results". In other words, bad faith is to be measured by a subjective standard, based upon actual knowledge, and an intentional, ie, purposeful and knowing failure to notify by the insured.

Whether or not an insurance company has acted in bad faith is a question of fact⁶⁷⁹. In *Unigard*⁶⁸⁰ the minimum standard for bad faith was stated to be gross negligence or recklessness. The Second Circuit refused to regard simple negligence in not disclosing a material fact as bad faith. The court found that if a reinsured deliberately deceives a reinsurer, that deception would amount to bad faith. The Second Circuit also clarified gross negligence as meaning that if a reinsured had implemented routine practices and controls to ensure notification to reinsurers but inadvertence caused a lapse, the reinsured has not acted in bad faith; but if a reinsured did not implement such practices and controls, then it had wilfully disregarded the risk to reinsurers and was guilty of gross negligence⁶⁸¹.

⁶⁷⁷ *Gerrard Realty Corp. v. American States Ins. Co.* 89 Wis 2d 130, 277 NW 2d 863 Wis, 1979.

⁶⁷⁸ *Unigard v North River* 4 F 3d 1049 CA2 (NY), 1993; *Christiania v. Great American* 979 F 2d 268 CA 2 (NY), 1992; *Certain Underwriters at Lloyd's London v. Home Ins. Co.* 146 NH 740, 2001.

⁶⁷⁹ *Certain Underwriters v. Home* 146 NH 740, 2001.

⁶⁸⁰ 4 F 3d 1049 CA2 (NY), 1993.

⁶⁸¹ It is noteworthy that in *Zenith v Wausau* 141 F 3d 300 CA 7 (Wis), 1998 the district court also believed that prejudice did not matter if the insured acted in bad faith. On appeal however the Seventh Circuit noted that the district court referred to New York cases *Unigard* 4 F 3d 1049 CA2 (NY), 1993 and *Christiania* 979 F 2d 268 CA 2 (NY), 1992 but the Seventh Circuit did not find appropriate to apply New York law in Wisconsin as they found no analog to that New York rule in Wisconsin law and held that therefore, either Zenith must show prejudice or Wausau must show the lack of it, depending on how late Wausau's notice was.

12.1.5 Waiver

Waiver is defined as “the intentional relinquishment of a known right”⁶⁸². Therefore it is necessary to show that the reinsurer possessed sufficient knowledge, actual or constructive, of the circumstances with regards to the unasserted defence, and also to produce direct or indirect evidence that the reinsurer intended to discard it⁶⁸³. Waiver can be express, or it can be implied where it can clearly be inferred from the circumstances⁶⁸⁴.

The Ninth Circuit in *National American v Certain Underwriters*⁶⁸⁵ agreed with the district court that the reinsurers’ delay constituted a waiver of any late notice defence they may have had. In this case, at the time the litigation commenced, the reinsured, National, was unaware of the reinsurance policies. However, after making inquiry via its brokers, on May 22, 1989, several years after National had undertaken its role in the assured’s defence, but several years before any settlement was reached, the brokers sent National copies of the certificates representing the two reinsurance policies. Nine days later, National sent a letter to the brokers giving them preliminary notice of a possible claim against the policies. By then, National had already incurred legal and investigation costs of approximately \$1.8 million.

Neither the brokers nor the reinsurers responded to the May letter or to subsequent letters. On January 9, 1991, National informed the brokers of the terms of the settlement agreement but did not receive any response. On January 25, 1991, National sought coverage for the reinsurers’ share of the associated costs as well as the liability coverage.

The Ninth Circuit stated that under California law, a reinsurer may invoke the defence of late notice so long as it immediately objected to the late notice, and suffered “actual and substantial prejudice.” (Cal. Ins. Code § 554). Despite receiving notice of the claim on May 31, 1989, the reinsurers did not object to the late notice until after suit was brought in July, 1991. While “promptly” is not specifically defined in Cal. Ins. Code § 554 the court found that delay more than two years was found not a prompt objection by any definition.

⁶⁸² *United Fire & Cas. Co. v. Arkwright Mut. Ins. Co.* 53 F Supp 2d 632 SDNY, 1999.

⁶⁸³ *Constitution v Stonewall* (980 F Supp 124; SDNY, 1997).

⁶⁸⁴ *Constitution v Stonewall*.

⁶⁸⁵ 93 F 3d 529 CA9 (Cal), 1996.

An example of a note which was held to have reserved the reinsurers' right to contest the reinsured's claim unequivocally is seen in *Constitution v. Stonewall* where the reinsurers wrote in their letter that "we question the late nature of your initial notice and subsequent report." In *Keehn v. Excess* the reinsured argued that the telegram that was sent by the reinsurer saying "Sorry but our records do not confirm Snow-Hartliep ever reported; please give us complete information." constituted waiver. The Seventh Circuit noted that an insurer must have knowledge of all the material facts before its conduct could constitute a waiver; the telegram indicated that the reinsurer had had no notice of the Snow accident and was requesting information. Without knowledge of material facts the court held that there could not be waiver.

12.2 Access to Records

Provisions entitling the reinsurer the right to inspect or audit the reinsured's books and records are known as "Access to Records" "Inspection of Records" or simply "Audit"⁶⁸⁶. An example of a formulation of an access to records clause is "The reinsurer or its designated representatives shall have free access to the books and records of the Company on matters relating to this reinsurance at all reasonable times for the purpose of obtaining information concerning this Contract or the subject matter hereof."⁶⁸⁷. Access to records is of importance for reinsurers, especially in determining if the reinsured acted reasonably and in good faith in handling and settling the underlying claims⁶⁸⁸. On the other hand, a reinsurers' failure to exercise the right of inspection may be interpreted in favour of reinsureds. In *Gerling Global Reinsurance Corp. v. Safety Mut. Cas. Corp.*,⁶⁸⁹ such a failure by the reinsurers was held to defeat a fraudulent concealment allegation in the absence of any indication that the reinsured failed to honour the access to records provision. It should also be noted that reinsurers' request to access to records must be at "reasonable times"⁶⁹⁰. Nevertheless, it was pointed out that in drafting an access to records clause the clause should provide that: there is a right to inspect all books and documents relating to business transferred to the reinsurer; the right of inspection survives contract

⁶⁸⁶ *New Appleman Guide*, 40.10[1].

⁶⁸⁷ *New Appleman Guide*, 40.39.

⁶⁸⁸ *The Law of Reinsurance Claims 1997 Supplement*, 85; *New Appleman Guide*, 40.10[1]. A reinsured is still obligated to provide the information reasonably requested by its reinsurer in the absence of a clause as such failing of which may cause denial of the reinsured's claim: *Michigan Mut. Ins. Co. v. Unigard Sec. Ins. Co.* 44 F 3d 826 CA9 (Wash), 1995.

⁶⁸⁹ 1981 US Dist LEXIS 13864.

⁶⁹⁰ *The Law of Reinsurance Claims 1997 Supplement*, 85.

termination; the inspection right vests in the reinsurer or in any of its authorised representatives; and access for inspection will be allowed at all reasonable times⁶⁹¹.

12.3 Right to associate (claims co-operation) clauses

A “right to associate”, also called “claims co-operation”⁶⁹², is the right of the reinsurer “to consult with and advise the reinsured in its handling of the claim.”⁶⁹³ Association is a discretionary right⁶⁹⁴, not a duty, although there is a corresponding duty on the part of the reinsured to make full and prompt disclosure of the information the reinsurer needs in order to decide whether to associate.⁶⁹⁵

Reinsurers’ biggest concern in using their right to associate in the handling of claim is that they may run the risk of being held directly liable to policyholders or third parties⁶⁹⁶. For instance in *Homan v. Employers Reinsurance Corp*⁶⁹⁷ an excess of loss reinsurance contract provided that it was “subject to” all of the general and special terms and conditions of the policies and endorsements reinsured thereunder. The reinsured became insolvent and the assured made claim against the reinsurer by relying on a judgment that was against the reinsured, the reinsurer having been involved in the defence of the assured’s claim. The Supreme Court of Missouri held that being subject to all of the general and special terms and conditions of the contract made the reinsurer liable to the assured but only to the extent of the coverage limit of the reinsurance policy. Moreover, the court found that, because the reinsurer took charge of and managed the defence of the assured’s action, that established a privity between the reinsurers and the assured. Consequently, even though the court recognised the general rule that there is no privity between the assured and the reinsurers, the abovementioned facts made the court distinguished this case from the general principle.

⁶⁹¹ *New Appleman Guide*, 40.10[1].

⁶⁹² Wollan, E, *Handbook of Reinsurance Law*, 2002, para 4.07.

⁶⁹³ *British v. Safety Nat.*

⁶⁹⁴ *New Appleman Guide*, 40.11

⁶⁹⁵ Wollan, para 4.07

⁶⁹⁶ See *Venetsanos v. Zucker, Facher & Zucker* 271 NJ Super 459, 1994 above under the “Privity of Contract” heading. *Slotkin v. Citizens Cas. Co. of New York* 614 F2d 301 CANY, 1979.

⁶⁹⁷ 345 Mo 650, 1939.

12.4 Claims control clauses

Another category of claim procedure clauses is “claims control clauses” which make the reinsurer by agreement in control of claims handling and disposition⁶⁹⁸. It is submitted that “claims control clauses” are wider than right to associate clauses because the former give the reinsurer control over claims settlements⁶⁹⁹.

Clauses requiring reinsurers’ consent for settlement is found in apparent conflict (or at least tension) with a follow the settlements clause if the reinsurance contract contains one⁷⁰⁰. No reinsurance case has in fact turned on this issue, but in the insurance context, in *Crowley Maritime Corp. v. Federal Ins. Co.*,⁷⁰¹ the insurer was held not to be liable to follow the assured’s settlements entered into without the insurer’s consent contrary to a policy term whereby the insured agreed not to settle any claim without the insurer’s written consent.

12.5 The effect of claims procedure clauses

12.5.1 Agency relationship between the reinsured and reinsurer

Agency is described as a “manifestation of consent of one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act”. In *Reid v Ruffin*⁷⁰², where the court put forward this definition, the reinsured agreed not to settle the assured’s claims falling within the reinsurance without the consent of the reinsurer, except in those instances where an immediate decision was necessary and it was impracticable to obtain the consent of the reinsurer (Article 8). The assured, Ruffin, was involved in an accident which caused serious injury to Reid. Reid brought an action against Ruffin, but prior to trial offered to settle the case for the policy amount, \$10,000, an offer to which the reinsured did not respond or inform the reinsurers. Later, the reinsured tried to settle but Reid refused. The matter went to trial and the jury awarded Reid a verdict of \$80,000. The court construed Article 8 as meaning that it did not require all decisions regarding settlement matters involving reinsurance to be approved by the

⁶⁹⁸ Wollan, para 4.07

⁶⁹⁹ In order to obligate the reinsured to confer with and secure the agreement of the reinsurer to settle claims of certain types or amounts in order to be indemnified claims control clauses sometimes are worded “counsel and concurrence” or “concur and consent” clauses. *New Appleman Guide*, 40.11

⁷⁰⁰ *New Appleman Guide*, 40.11; Staring §17:3

⁷⁰¹ Slip Copy, 2008 WL 5071118 NDCal, 2008 (applying California law).

⁷⁰² 503 Pa 458, 1983.

reinsurers. The reinsurers were given no control over decisions by the reinsured not to settle a claim and, the reinsurers could not direct the reinsured to accept an offer of settlement if for some reason the reinsured was unwilling to do so.

The court saw no general agency relationship, and made it clear that Article 8 authorised the reinsured to act on behalf of the reinsurer only “in those instances where an immediate decision is necessary and it is impracticable to obtain the consent of the Reinsurer.”

Otherwise, a settlement was not to be made without the reinsurer’s consent. Thus, if the reinsured can be said to be the agent of the reinsurers, it is only to the limited situation in which an immediate decision *to settle* was necessary. Therefore a finding of bad faith was the reinsured’s decision *not to settle*, a decision over which the reinsurers had no control, the bad faith of the insurer cannot be imputed to the reinsurer.

However if the clause clearly so states, the reinsured might be regarded as acting as an agent of the reinsurer in defending the claim. In *Commercial Assur. Co. v. American Cent. Ins. Co.*⁷⁰³, where there was no follow the fortunes clause, upon the notification of the loss the reinsurer and the reinsured refused to pay. The assured then brought an action against the original insurer to recover the loss and the two companies again agreed that the action should be resisted and contested, and that the original insurer, as defendant in the action, should have the conduct, management, and control of the contest for itself and as agent of the reinsuring company. However the reinsured abandoned the defence and compromised and settled the claim with the assured. The Supreme Court of California held that such an authorisation required the reinsured to defend the action until the question of liability was adjudicated. Under the authority it was given by the agreement with the reinsurer the reinsured had no power to compromise and settle the claim to bind the reinsurer unless the latter had knowledge of the compromise, and consented to it or approved of it.

12.5.2 Attorney-client privilege

In commercial disputes it is permitted in the US for the parties to request from each other documents to help them prove their respective cases⁷⁰⁴. However, if a document is subject to the attorney-client privilege it will be immune from discovery⁷⁰⁵.

⁷⁰³ 68 Cal 430, 1886.

⁷⁰⁴ Hammesfahr 94, 136.

⁷⁰⁵ Hammesfahr 2004, 269.

The documents that are subject to the privilege are stated to be⁷⁰⁶:

- 1- Claims counsel reports regarding the defence of the assured's claim
- 2- Expert reports or analyses of a claim by the insurer's or insured's personnel concerning the defence of a claim
- 3- Coverage analyses by the reinsured's in-house or outside counsel; and
- 4- Draft arguments and communications with counsel regarding those pleadings

If the parties have a common interest on a particular issue, disclosure of documents is not to be restricted on the basis of the attorney-client privilege⁷⁰⁷. In that situation, communications made to the shared attorney to establish a defence strategy remain privileged as to the rest of the world. However, it is accepted that reinsurers and reinsureds do not share a common interest. The issue arose in *North River Ins. Co. v. Columbia Cas. Co.*⁷⁰⁸ where the arbitrator decided that *North River* was obliged to pay the assured's attorney's fees in defending third party asbestosis claims. *North River* then claimed those fees from the reinsurers *Columbia*. The reinsurers requested sight of the documents between *North River* and their attorney in respect of defending the assured's own claim for defence costs. *North River* argued that those documents were protected by attorney-client privilege. The Court clarified that the common interest doctrine applies when multiple persons were represented by the same attorney and therefore rejected the reinsurers' contention that the doctrine was applicable to the reinsurance relationship. For example if an insurer actually retained counsel to provide a defence for the insured, there was a common legal interest between them. Therefore, the mere fact that the parties had a reinsurer - reinsured relationship was insufficient to find that they shared a common interest. The court also noted that *North River* and *Columbia* were not represented by the same counsel, and *Columbia* did not contribute to *North River*'s legal expenses nor exercise any control over its conduct of the proceedings. Nor was there any evidence that the two parties co-ordinated litigation strategy in any way. While their commercial interests coincided to some extent, their legal interests sometimes diverged, as demonstrated by the instant litigation.

⁷⁰⁶ *New Appleman Guide*, 40.10[3][a].

⁷⁰⁷ However, privilege against a third party is still applicable: *New Appleman Guide*, 40.10[2][b].

⁷⁰⁸ F Supp, 1995 WL 5792 SDNY, 1995, (applying New York law).

A cooperation clause does not waive attorney client privilege⁷⁰⁹. In *North River Ins. Co. v. Philadelphia Reinsurance Corp.*⁷¹⁰ the “co-operation clause” in the reinsurance contract provided “The company [North River] shall furnish the Reinsurer with a copy of its policy and all endorsements thereto which in any manner affect this certificate, and shall make available for inspection and place at the disposal of the Reinsurer at reasonable times any of its records relating to this reinsurance or claims in connection therewith.” The court recognised that a reinsured may contractually be bound to provide its reinsurer with all documents or information in its possession that may be relevant to the underlying claim adjustment and coverage determination. However, according to the judge, more explicit language was required to achieve that result. A co-operation clause did not mean that the reinsured waived wholesale its right to preserve the confidentiality of any consultation it might have with its attorney concerning the underlying claim and determination of its coverage. The court also stated that under a co-operation clause a reinsurer is not entitled to be apprised of legal advice obtained by a reinsured with a “reasonable expectation of confidentiality”. It was enough to satisfy its obligations under the cooperation clause to make available to the reinsurer all factual knowledge or documentation in its possession relevant to the underlying claim or the handling of that claim.

However it should be noted that if a reinsured discloses the documents in any other litigation with other parties, such disclosure amounts to a waiver of privilege. In *North River v. Columbia* it was mentioned that North River disclosed documents in litigation against CIGNA in circumstances where North River and CIGNA had no common legal interest. Therefore North River was held to have waived the attorney-client privilege with respect to the documents that it had disclosed in the litigation against CIGNA, and Columbia was held to be entitled to see those documents without any attorney-client privilege restriction.

⁷⁰⁹ Nor a standard access to records clause. In *Gulf Insurance Co. v Transatlantic Reinsurance Co*, 788 NYS2d 44 NYAD 1 Dept, 2004, the reinsurance contract provided that “the Reinsurers ... will have the right to inspect ... all records of the Company [ie plaintiff] that pertain in any way to this Agreement.” The Supreme Court of New York Appellate Division held that a standard access to records clause in a contract did not waive any claim of privilege with respect to those documents.

⁷¹⁰ 797 F Supp 363 DNJ, 1992.

CONCLUSION

Reinsurance is insurance taken out by insurers, in order to maintain their solvency by risk-spreading, and in order to expand their capacity to write additional risks. Much of the world's reinsurance business is placed in the London market, with substantial benefits to the UK economy. Reinsurance is also a means of obtaining business for London which would otherwise not be written at all: in many jurisdictions, only local insurers are licensed to carry on insurance business, so those that do not have the inclination or capacity to write a particular risk may nevertheless do so but then transfer to external reinsurers anything up to 100 per cent of that risk.

Reinsurance may be written in many forms, but the focus of this thesis is facultative proportional reinsurance, whereby a single risk is reinsured by a reinsurer. Thus, if a factory is insured against fire by insurer A, A may transfer a given percentage of the risk – say, 30 per cent – to reinsurer B in exchange for an equivalent percentage of the premium: if the factory is destroyed by fire, B indemnifies A for 30 per cent of its payment to the assured. This arrangement presumes that (subject to financial limits) the original insurance and reinsurance provide identical cover.

Defining the nature of such a transaction is crucially important in the interpretation of reinsurance contracts, because classifying reinsurance as a liability cover creates a direct link between the sums paid by the reinsured and the reinsurer's obligation to provide an indemnity, with the back-to-back terms of the reinsurance simply confirming that the reinsurers will pay when the reinsured has to pay. By contrast, if reinsurance is a further contract on the original subject matter, attention focuses on the terms of the reinsurance rather than the liability of the reinsured.

In the first part of the thesis an attempt has been made prove that in a facultative reinsurance, the reinsurer insures the reinsured's liability that the latter has undertaken under the original insurance with the assured.

The issue had not been settled in England until the House of Lords decision in *WASA International Insurance Co Ltd v Lexington Insurance Co*⁷¹¹ where the House of Lords unanimously held that reinsurance is a further insurance on the subject matter insured by the reinsured. The Court of Appeal's decision on the issue has been discussed in various parts of this thesis. After the thesis was submitted, the House of Lords decided on the dispute. Their Lordships' ruling has been added to the conclusion after the thesis was examined.

In *Wasa v Lexington*, a US insurer, Lexington, insured Aluminum Company of America (Alcoa) under an all risks property damage and business interruption policy issued for a three-year period from 1 July 1977. The insuring clause covered "all physical loss of, or damage to, the insured property ..." The insurance also contained a standard Service of Suit clause: "In the event of the failure of [Lexington] to pay any amount claimed to be due hereunder, [Lexington] at the request of the Insured, will submit to the jurisdiction of any Court of Competent jurisdiction within the United States and will comply with all requirements necessary to give such Court jurisdiction and all matters arising hereunder shall be determined in accordance with the law and practice of such Court". The reinsurers in the present litigation, Wasa and AGF, reinsured 2.5 per cent in total of Lexington's risk. The reinsurance was stated to be a "Contributing Facultative Reinsurance" covering "All Risks of Physical Loss or Damage excluding Fire and Allied Perils &/or as original". Period was stated to be for "36 months at date 1.7.77 ... and/or pro rata to expiry of original", conditions were "Full R/I Clause No. 1 amended". Premium was said to be calculated at GOR [Gross Original Rate]. The Full Reinsurance Clause was not identified but it was common ground that the wording was "Being a reinsurance of and warranted same gross rate, terms and conditions as and to follow the settlements of the Company and that said Company retains during the currency of this Policy at least on the identical subject matter and risk and in identically the same proportion on each separate part thereof, but in the event of the retained line being less than as above, Underwriters' lines to be proportionately reduced."

Alcoa was instructed by the US Environmental Protection Agency to clean up contamination which had occurred at various of its sites. Further investigation showed that damage had occurred as early as 1940s at some 35 sites within, and 23 outside, the United States. Proceedings were commenced against the insurers on risk from 1940s until 1990

⁷¹¹ [2009] UKHL 40.

although a number could not be identified or had gone out of business. The case went to the Washington Supreme Court. The Court, applying Washington conflict of laws rules⁷¹², held that the governing law was that of Pennsylvania. Applying that law, the Court ruled that the wording of the insuring clause in Lexington's policy meant that Lexington was liable for all of the damage as long as any part of it occurred in the three year coverage period. The outcome was that Lexington was jointly and severally liable for the damage occurring before 1 July 1977, in the three years of coverage and even thereafter. In effect, therefore, the Court's interpretation of the policy was that the insuring clause overrode the time period clause in the policy.

Lexington settled Alcoa's claim following the Washington Supreme Court decision and then made its own claim against the reinsurers for their respective proportions. 97.5 per cent in value paid up, but both Wasa and AGF denied liability and sought negative declaratory relief in England. It was common ground that the reinsurance contract was governed by English law, and the reinsurers sought a declaration that the duration clause was also governed by English law: it was again common ground that under English law there could have been liability only for the damage actually occurring in the period of coverage⁷¹³.

Simon J⁷¹⁴ at first instance held that the reinsurance contracts were not proportional,⁷¹⁵ although he accepted that the contracts were largely written on a back-to-back basis. He also ruled that reinsurance was not a liability cover but rather a further insurance on the subject matter insured, so that the interpretation of the reinsurance and original insurance contracts was independent and a matter for the governing law of each. The mere fact that Lexington had established and quantified its liability was not enough to trigger reinsurance cover. Simon J emphasised that the contracts were not back-to-back in respect of the period clause which was fundamental and had to be construed according to its own terms and under English law.

Lexington appealed, and in the Court of Appeal⁷¹⁶ the key question was whether the time period clauses in the two contracts should be given the same interpretation despite the differing applicable laws. The Court of Appeal gave a positive answer, but the House of

⁷¹² Held to be the effect of the Service of Suit clause by the lower court.

⁷¹³ On the strength of *Knight v Faith* (1850) QB 649.

⁷¹⁴ [2007] Lloyd's Rep IR 604.

⁷¹⁵ This was plainly wrong and the point did not emerge on appeal. In the House of Lords Lord Mance noted that the reinsurance was not "perfectly proportional" because part of the premium had been returned to the reinsured by way of commission. However, it is standard practice in facultative cases to pay the reinsured a small "finder's fee" commission and nothing turned upon the point.

⁷¹⁶ [2008] Lloyd's Rep IR 510.

Lords⁷¹⁷ allowed the appeal and restored Simon J's judgment. In so deciding their Lordships ruled that: (1) reinsurance is not liability insurance so that mere proof by the reinsured that it faced liability does not permit a claim to be brought; and (2) the reinsurers were entitled to rely upon the English law construction of the reinsurance policy to restrict their liability to damage occurring in the 36-month period of cover.

In *Wasa* the House of Lords was unanimously of the view, expressed by Lord Mance that "The insurable interest which entitles the insurer to reinsure in respect of that subject-matter is the insurer's exposure under the original insurance"⁷¹⁸. Lord Mance stated that the subject matter insured by the reinsurance in *Wasa* was, by reason of the headings "interest" and "situated", the original assured's property, rather than the insurer's exposure or liability under the original insurance. However, in the same paragraph, Lord Mance added that the insurable interest which entitled the insurer to reinsure in respect of that subject-matter was the insurer's "exposure under the original insurance". These two statements seem to contradict each other because their Lordships state on the one hand that the subject matter of the reinsurance contract is the original assured's property but not the reinsured's liability under the direct policy; but on the other hand their Lordships confirm that the reinsured's insurable interest is its exposure under the primary insurance policy. The better view, it is submitted, is that the interest clause merely identifies the insured subject matter, and does not seek to define the reinsured's insurable interest. It identifies what the subject matter insured is because that forms the reinsurer's liability. The liability insurance approach is also consistent with the settled rule that the trigger for payment by the reinsurer is the establishment and quantification of the reinsured's loss, and not the occurrence of a peril insured against under the direct policy⁷¹⁹. It is also to be commented that four of their Lordships, Lord Mance apart, felt that in purely commercial terms there was something to be said for treating reinsurance as liability insurance⁷²⁰, and there was unanimity that a policy could (and perhaps should) be drafted in that way if appropriate words were used. Their Lordships rejected Lexington's argument – persuasive in the view

⁷¹⁷ [2009] UKHL 40.

⁷¹⁸ [2009] UKHL 40, at [33].

⁷¹⁹ *Commercial Union Assurance Co Plc v NRG Victory Reinsurance Ltd* [1998] Lloyd's Rep IR 439.

⁷²⁰ What appears to have stopped their Lordships from reaching that conclusion as a matter of law (apart from the fact that Lexington did not rely upon the point in argument) was the implications for regulation under the Financial Services and Markets Act 2000. Treating reinsurance as liability insurance would have undermined the class by class authorisation of insurance business applicable to reinsurers, a structure which their Lordships were not prepared to undermine in a purely private dispute without representations from the regulatory authorities.

of the present author – that the wording of the reinsurance did just that, and indeed that it would have been difficult to think of what more could have been done.

In *Wasa* the contracts were worded in more or less identical terms. The original policy was for three year period from 1 July 1977 until 1 July 1980. The reinsurance contracts were for 36 months from 1 July 1977. The reinsurance was as original and contained the Full Reinsurance Clause. Lord Mance accepted that “&/or as original” against the headings “form” and “interest” “on any view incorporated the relevant insurance provisions relating to the subject matter and risks into the reinsurance”⁷²¹. Thus the reinsurance wording matched that of the original and it follows that the insuring clause on which the Washington Supreme Court based its decision was also a clause of the reinsurance contract. The only question was whether the fact that the two contracts had different applicable laws required them to be construed differently.

In order to recover under a facultative proportional reinsurance the reinsured must, in accordance with the *Scor*⁷²² case: (a) establish its own legal liability to the assured, which it can do by being sued to judgment in a court of competent jurisdiction (or in arbitration) by a ruling which is not perverse⁷²³; and (b) show that the loss falls within the terms of the reinsurance. In *Wasa*, the question was with the second limb of the *Scor* test, ie if the loss fell within the reinsurance cover. In relation to this, the question was also how to interpret the reinsurance policy which contained identical terms to the original insurance. Even though if the reinsurance policy provides a follow the settlements clause, it is always open to a reinsurer to raise any defence that is provided for by the reinsurance. However, the requirement has to be considered together with the back-to-back presumption. If the contracts provide identical cover, in that the reinsurance does not contain any additional exclusion clauses, the reinsurer is liable when the reinsured is liable. If the reinsured makes an *ex gratia* payment, eg, when aware that the claim is probably not covered by the original insurance contract, the settlement cannot be described as “bona fide and businesslike” and consequently the requirements of the follow the settlements clause will not be met. On the other hand, if the reinsured settles the claim in good faith, believing that the claim is covered by the original insurance, the reinsurer has agreed to follow the reinsured’s good faith settlements and will be obliged to make payment to the reinsured even if it can subsequently be proved that the reinsured was not liable. In the light of these

⁷²¹ [2009] UKHL 40, at [21].

⁷²² *Insurance Co of Africa v Scor (UK) Reinsurance Co Ltd* [1985] 1 Lloyd’s Rep 312.

⁷²³ *Commercial Union Assurance Co Plc v NRG Victory Reinsurance Ltd* [1998] Lloyd’s Rep IR 439. But see the comments of Lord Mance, discussed below.

principles, where the contracts are back-to-back it is difficult to see that the reinsurer can have any policy defence to a claim brought by the reinsured under the follow the settlements clause⁷²⁴. However, the courts have been reluctant to accept that the second limb of the *Scor* test is automatically satisfied in this way. In *Assicurazioni Generali SpA v CGU International Insurance Plc* Gavin Kealey QC⁷²⁵ held that where the reinsurance and original insurance are back-to-back and the reinsurance contract contains the full reinsurance clause, the reinsurers are not “dictated” to indemnify the reinsured for a settlement made in a bona fide and businesslike fashion. The Court of Appeal⁷²⁶ on appeal, relying on *Charman v Guardian Royal Exchange Assurance*⁷²⁷ and *Baker v Black Sea and Baltic General Insurance Co Ltd*,⁷²⁸ approved this analysis, and held that it remained necessary for the loss to fall within the scope of the reinsurance or at least “arguably so”. This reasoning was approved, without detailed analysis, by the House of Lords in *Wasa*.

The issue in *Wasa* was purely related to the construction of terms of the reinsurance agreement. As the reinsurance and original insurance contracts were worded identically, the interpretation of the original insurance should have been binding for the reinsurers. The precedent cases *Forsikringsaktieselskapet Vesta v Butcher*⁷²⁹ *Groupama Navigation et Transports v Catatumbo CA Seguros*⁷³⁰ established that where the reinsurance and original insurance contracts are governed by different applicable laws, the interpretation of the original insurance contract terms by a foreign law will be binding for English reinsurers. In *Wasa*, the insuring clause which was worded “This policy insures against all physical loss of, or damage to, the insured property ...” was thus also a clause of the reinsurance policy. The original insurance was drafted for three years, the reinsurance for 36 months. The Washington Supreme Court interpreted the original insurance contract terms as a whole, including the insuring clause and the time period clause, and held that the words “all loss...” meant there was no exclusion relating to time limits. According to the principles of construction of the terms of facultative proportional reinsurance contracts

⁷²⁴ Clearly, reinsurers are entitled to provide for reinsurance policy defences that are not open to the reinsured under the original insurance; in such cases, the reinsurance and direct insurance policies will not to that extent be back-to-back and reinsurers will be able to rely on their own defences.

⁷²⁵ [2003] 2 CLC 852, 871-872.

⁷²⁶ [2004] Lloyd’s Rep IR 457.

⁷²⁷ [1992] 2 Lloyd’s Rep 607.

⁷²⁸ [1995] LRLR 261.

⁷²⁹ [1989] 1 Lloyd’s Rep 331.

⁷³⁰ [2000] 2 Lloyd’s Rep. 350.

which were established by the House of Lords in *Vesta v Butcher* and by the Court of Appeal in *Groupama v Catatumbo*, the interpretation of the original policy was in principle also applicable to the reinsurance. However, the House of Lords classified *Wasa* as “exceptional” and that it was to be distinguished from *Vesta* and *Groupama*. This was so because in the two earlier cases it had been possible at the time when the insurance and reinsurance were placed to identify the foreign law which would govern the insurance. However, according to their Lordships, it would be fanciful to suppose that in 1977 the hypothetical American lawyer asked to advise on what law governed the contract of insurance, and what law would govern questions of coverage, would have concluded that Pennsylvania law would have applied⁷³¹. The distinguishing feature for their Lordships was, therefore, the uncertainty created by the Service of Suit clause, and the principle that reinsurers could not be expected to follow the reinsured’s liability in circumstances where it was not clear which law would govern that liability. It is to be noted that the House of Lords did not accept Simon J’s first instance ruling that English law should be applied to the reinsurance duration clause by reason of the fact that the interpretation given to that clause in the direct policy by the Washington Supreme Court was not one which could have been predicted in 1977. As their Lordships emphasised, it was trite law that insurers and reinsurers ran the risk of changes in the law or in contractual interpretation. There was no attempt by the reinsurers to argue that the Washington Supreme Court’s decision was “perverse” and outside the range of rulings capable of being recognised as establishing and quantifying the reinsured’s liability, and Lord Brown emphasised that, however surprising to English eyes it might have been, the Washington Supreme Court decision could not be disputed⁷³². The determinative uncertainty in the present case was related to the law applicable to the direct policy.

The main concern of the House of Lords in *Wasa* appeared to have been that, if the two contracts were to be interpreted in the same way, the reinsurers would have been liable for losses for the entire period of contamination even had the reinsurance not been for a matching period of three years but for some lesser period. Their Lordships thus put emphasis on the fundamental nature of the temporal scope of a time policy. Lord Collins pointed out⁷³³ that if the reinsurance contracts had been drafted for any lesser period:

⁷³¹ [2009] UKHL 40, at [107].

⁷³² [2009] UKHL 40, at [12].

⁷³³ [2009] UKHL 40, at [111].

‘The periods of cover under the insurance and reinsurances would not be back-to-back. But Lexington would still be maintaining that, in the light of the decision of the Washington Supreme Court, if any damage occurred within any relevant policy period, of any duration, the relevant reinsurer would be liable for all of the damage, including damage occurring before inception or after expiry. That seems to me to be wholly uncommercial and outside any reasonable commercial expectation of either party’⁷³⁴.

This, with respect, does not follow. If the reinsurance had not been for 36 months then the two contracts would not have been back-to-back and it would have been perfectly proper to construe the reinsurance in accordance with English law. But the fact is that the two contracts were of the same duration, and this was not doubted by any of their Lordships.

What we are left with, therefore, are two cases – *Vesta* and *Groupama* – in which warranties in a contract governed by English law were construed in accordance with a foreign law in order to achieve back-to-back cover with the underlying insurance, and one case – *Wasa* – in which a duration clause governed by English law was construed in accordance with English law so as to deny back-to-back cover with an all but identically worded direct policy whose terms had been incorporated into the reinsurance. What is the general rule in this type of case? The answer is unclear. Lord Collins commented⁷³⁵ that

‘In the case of proportional facultative reinsurance the obvious commercial intention is for the original insurer to reinsure part of its own risk and for the reinsurer to accept that part of the risk, and it is therefore equally obvious that the relevant terms in the reinsurance contract should be construed so as to be consistent with the contract of insurance. This is simply commercial common sense. Consequently, in proportional facultative reinsurance the starting point for the construction of the reinsurance policy is that the scope and nature of the cover in the reinsurance is co-extensive with the cover in the insurance.’

His Lordship added:⁷³⁶

⁷³⁴ See also Lord Brown, [2009] UKHL 40, at [15].

⁷³⁵ [2009] UKHL 40, at [60].

⁷³⁶ [2009] UKHL 40, at [116].

‘it would almost invariably be the case that losses for which the insurer has indemnified the original insured would be within the reinsurance even if the losses are payable under a foreign law or a foreign judicial decision which takes a view different from English law of what losses are recoverable’

What, for Lord Collins, distinguished *Wasa* from *Vesta* and *Groupama* was that in 1977 there was no identifiable system of law applicable to the direct policy, so the parties must have intended English law to apply to the reinsurance. Lords Walker and Brown agreed with this judgment. Contrast Lord Mance, who focused on the commercial and legal unattractiveness of imposing the over-technical English law of warranties on reinsureds⁷³⁷ and commented that “Absent a common governing law, reinsurers may still sometimes be entitled to respond, with reference to the clear meaning that their contract has under the law governing it”⁷³⁸. So Lord Collins regarded *Wasa* as highly exceptional, a deviation from what would “almost invariably” be held, whereas for Lord Mance the warranties cases are exceptional and *Wasa* may be closer to the general rule than *Vesta* and *Groupama*. In a market which demands commercial certainty, their Lordships appear to have provided the very opposite.

Another point that now is questionable after *Wasa* is whether or not a foreign court decision is binding on reinsurers if the parties to the reinsurance contract could not identify the applicable law to the original insurance at the outset of the contract. In *Commercial Union Assurance Co Plc v NRG Victory Reinsurance Ltd*⁷³⁹ it was held that the judgment of a foreign court establishing and quantifying the liability of the reinsured will be binding on the reinsurers and thus on an English court charged with determining the question whether the reinsured has established and quantified its liability for the purposes of a reinsurance claim. The only defence that could be raised by the reinsurers in *Wasa* was that the Washington Supreme Court decision was manifestly perverse but the reinsurers did not argue that the decision was perverse, and it was not disputed that the Washington Supreme Court was a court of a competent jurisdiction and that the proceedings were brought in compliance with the Service of Suit clause. The reinsured’s liability was thus established. If reinsurance is liability insurance, the problem would have been solved at this stage because where the reinsurance and insurance contracts provide

⁷³⁷ [2009] UKHL 40, at [50].

⁷³⁸ [2009] UKHL 40, at [51].

⁷³⁹ [1998] Lloyd’s Rep IR 439.

identical cover with almost identical terms and where the reinsured established its liability to the assured by a settlement following a judgment against the reinsured, the reinsurers will be liable for their reinsured proportion of the risk. The follow the settlements clause thus removes from the reinsured the need to establish its own liability as a matter of strict law, but, according to the *Generali* case and to *Wasa*, this does not remove the need for the reinsured to establish the reinsurer's legal liability under the reinsurance even though the two contracts are identically worded. It may be thought that this approach serves to undermine, albeit to a limited and as yet uncertain extent, the efficacy of a follow the settlements clause, but the law is nevertheless settled. The point as applied to *Wasa*, therefore, was that the reinsurers were entitled to rely upon the terms of their own policy despite the cover being back-to-back and the reinsurers being obliged to follow settlements.

One comment of Lord Mance is particularly troubling. His Lordship commented, speaking of *Commercial Union v NRG Victory*, that "It is unnecessary to decide upon the correctness or otherwise of the Court of Appeal's obiter observations on the effect under reinsurance of a judgment against the insurer."⁷⁴⁰ If this is right, then in the absence of a follow the settlements clause it may not be enough for a reinsured who wishes to establish and quantify his own liability to the assured, for the reinsured to be sued to judgment in a foreign court. This makes the task of a reinsured even more difficult and creates yet more uncertainty.

The House of Lords' decision in *Wasa* had been awaited by the reinsurance market by the hope that it would provide clarity on some of the major issues in the interpretation of proportional facultative reinsurance contracts. Their Lordships reached a result that the market will doubtless welcome. However, their Lordships' reasons for distinguishing *Vesta* and *Groupama* are contradictory and unconvincing, and throw into doubt the significance of the presumption of back-to-back cover. It is particularly difficult to understand why the decision of a court of competent jurisdiction on the meaning of the direct policy should not be regarded as conclusive of that liability whether or not there is a follow the settlements clause.

⁷⁴⁰ [2009] UKHL 40, at [37].

It is of course true that the reinsurers are not parties to the proceedings between the assured and the original insurer⁷⁴¹. However, attention should be given to the nature of the facultative proportional reinsurance contracts and how they are performed. The direct policy in *Wasa* contained a Service of Suit clause, and it was the uncertainty generated by that clause which persuaded their Lordships that the reinsurers should be entitled to rely upon the English law construction of the duration clause. But if the direct policy had not contained any law or jurisdiction clause, the position would have been exactly the same because the law applicable to the direct policy could not have been predicted.

Lord Collins stated that “One can...readily assume that a reinsurance contract was intended to cover the same risks on the same conditions as the original contract of insurance, in the absence of some indication to the contrary”. However, it is hard to see in the reinsurance contract in *Wasa* any contrary intention showing that the reinsurance and insurance contracts should not be interpreted in the same way. Lord Phillips expressed the opinion that if the parties had agreed implicitly that whatever law might be applied to interpretation of the primary cover and whatever result this might produce, applied equally to the reinsurance then that would effectively treat the reinsurance contract as one to indemnify the reinsured in respect of any liability sustained under the primary cover⁷⁴². This comment would undoubtedly be correct if the original insurer made a claim for an *ex gratia* payment or a claim that was not covered by the reinsurance policy by reason of an express reinsurance exclusion which did not appear in the direct policy. But in this case the contracts had identical wordings and the insurer paid by reference to the interpretation by a court of competent jurisdiction of the original policy term which was reproduced in the reinsurance policy. The insurer did not claim for an *ex gratia* payment, but made a claim under the original policy which the reinsurer agreed to cover and which was also incorporated by the words of “as original”.

Their Lordships implicitly recognised that their ruling was uncommercial. They went to great lengths to explain how the problems created by their decision could be avoided, eg, by making both contracts subject to the same applicable law or by framing the reinsurance as a liability cover. For the future these solutions may be effective, but for contracts

⁷⁴¹ Although in fact they may be if the insurers are acting as a front for the reinsurers and the reinsurance cover is 100 per cent.

⁷⁴² [2009] UKHL 40, at [8].

written before the ruling in *Wasa* the market will continue to be faced with great uncertainty as to exactly what the reinsurance covers.

In addition to the discussion on the nature of facultative reinsurance, the thesis also tried to identify the scope of the follow the settlements clause. With regards to the reinsured's claim against the reinsurer, there are two different limbs of liability that must be proved: 1- reinsured's liability to the assured; 2- reinsurers' liability to the reinsured. The first limb is related to the original insurance policy and where the reinsurance contract provides a follow the settlements clause and where the reinsured settles the claim by acting in a bona fide and businesslike manner he does not have to prove that he was actually liable to the assured. Even though it could be later proved that the reinsured was not liable to the assured, the reinsurers will still be obliged to follow the settlements as they agreed to be bound by any settlement which is bona fide and businesslike. The second limb is related to the reinsurance policy. Where the reinsurance and original policies are back-to-back, clearly, the reinsurance policy terms will be no different than those of the original policy and the reinsurers will be obliged to follow the settlements where the reinsured's liability to the assured is established. Unless the reinsurance policy contains any terms that the original insurance does not provide for, the reinsurer seemingly has no defence against the reinsured where the settlement is bona fide and businesslike or where the reinsured's liability is established by a judgment or an arbitration award. However, this principle should be approached with caution after *Wasa v Lexington*. The law is not clear after the decision but what is obvious is that if the parties could not identify at the outset of the contract which law would govern the contract of insurance, the reinsurer may still be able to bring reinsurance policy defences even though the original insurance contract was identical to the reinsurance contract and the reinsured was unsuccessful in bringing the defence in question against the assured in a court of competent jurisdiction outside England. In such a case, even though the original insurance is identical to the reinsurance policy, and even though the reinsured brought its policy defences in a dispute before a court outside England, if the court interprets the original insurance contract in a way that the defence is not valid and the reinsured is liable according to the interpretation of the original contract wording which is identical to the reinsurance policy, if the reinsurance policy is governed by English law, before an English court the reinsurers will still be able to raise the same defences that the reinsured had unsuccessfully pleaded in the foreign

jurisdiction. This clearly does not provide for contract certainty but this is nevertheless the ruling of the House of Lords in *Wasa*.

The wording of the follow the settlements clause may be varied or may be qualified. Clauses such as where the reinsurer will agree to follow the settlements whether “liable or not liable” or “without question” have been held not to change the *Scor* interpretation of the follow the settlements clause. However, if the clause is qualified, as where the reinsurer agrees to follow the settlements if the loss is “within the original insurance” and reinsurance policy terms, in this case proof of a bona fide and businesslike settlement will not be enough and the actual proof of liability under the direct policy will be required.

It is sometimes the case that a reinsurance policy provides a follow the settlements clause as well as a claims provision. Claims provisions may be in the form of notification clauses which require the reinsured to notify the reinsurers of the assured’s claim; or they may require the reinsured to seek the reinsurers’ consent before entering into any settlements with the assured. These two categories of claims provisions are called “claims co-operation” clauses. Claims control clauses are the other form of claims provision, under which the reinsured may be obliged to pass to the reinsurers the control of the negotiations with the original assured. If a claims control clause or a consent clause is in the reinsurance contract as well as a follow the settlements clause the question will be how to reconcile these two different types of terms. In other words, on the one hand the reinsurers express their trust in reinsured’s settlement, but on the other hand they require the reinsured to seek their consent prior entering into any settlements with the assured. The answer depends on the status of claims provisions. If the claims provision is a condition precedent, in case of the breach of the clause, the reinsurers will be discharged from any liability affected by the breach. If the clause is not a condition precedent, according to the *Scor* case, the follow the settlements clause will be emasculated by the breach of the claims provision but as it was pointed out in the thesis this solution is not supportable. If the claims provision is not a condition precedent but a mere condition or an innominate term and if the breach is not so serious that does not go to the root of the contract, the reinsured should be entitled to make a claim against the reinsurers where the settlement is bona fide and businesslike and the reinsurers will be entitled to claim their damages for the breach of the claims provision.

The thesis also tried to explore the application of settlement clauses in the United States. The research on the law of the United States mainly focused on the settlement clauses because the US cases did not demonstrate many disputes on the incorporation clauses. The nature of reinsurance contracts is not controversial in the US as it is accepted that reinsurers insure reinsureds' liability under the original insurance policy. Incorporation of arbitration clauses however may be possible by virtue of a general incorporation clause. Moreover, insurance and reinsurance are assumed to provide concurrent coverage where the reinsurance policy is "subject to the same terms and conditions as original".

In the US the terminology of the settlement clauses may differ that follow the settlements may be expressed as follow the fortunes in some of the reinsurance policies. However, it is now commonly accepted that these two forms of clauses are used interchangeably, the meaning of the two clauses are not different from each other. The settlement clauses are interpreted in the same way as in England, and they operate to prevent the reinsurers' from making a "de novo" review where the reinsured's settlement is in good faith and where the loss falls within the reinsurance cover.

By way of contrast with English law, in the US there is an issue as to whether a follow the settlements clause is implied into all reinsurance contracts. The majority view is that unless the reinsured proves that there is a custom as to the implication of the clause, implication into all reinsurance contracts is to be rejected. The dispute has not arisen in England yet but in the US reinsureds' post-settlement allocations as regards long tail risks such as asbestos and environmental claims has led to a good deal of litigation. The law, however, is now settled that it is almost impossible to distinguish post-settlement allocations from settlements to the effect that where the settlements are made in bona fide and businesslike manner, the post-settlement allocations are binding for the reinsurers. The only situation in which the reinsurer may object to a post-settlement allocation is where the reinsured includes an ex-gratia payment within the post-settlement allocation.

Claims provisions are in use in the US as well. The terminology however may differ and claims co-operation clauses may be defined as "right to associate" clauses. It should be noted that most of the cases on claims provisions in the US are on claims notification clauses as in that jurisdiction the reinsurers are worried that if they interfere with the settlement process with the assured or if they are involved in the defence process in a

dispute between the assured and the reinsured, the assured may argue that such an interference or involvement by the reinsurers has established privity between the assured and the reinsurers which would entitle the assured to bring a direct action against the reinsurers. The remedy for breach of claims provisions in the US also depends on the nature of the clause. Where the clause is a condition precedent, the reinsurers are discharged from liability that is tainted by the breach. However, the law differs from state to state. For instance in New York and in California, where the clause is not a condition precedent, the reinsurers have to prove that they are prejudiced by the breach and prejudice is not required where the claims provision is a condition precedent, but in North Carolina proof of prejudice is required even though the clause is a condition precedent. Some jurisdictions such as New York and California do not recognise any presumption of prejudice. However, being deprived of their contractual rights to control the negotiations with the assured creates the assumption that the reinsurers are prejudiced by the breach and the reinsured has to prove the contrary. If reinsurers cannot prove that they are prejudiced, but can prove that the reinsured acted in bad faith in failing to comply with the claims provision. They may also be discharged from liability. Proof of bad faith requires showing gross negligence or deliberate recklessness by the assured. However, in Wisconsin the Appeal court has refused to accept the “bad faith” exception.

The main question that the thesis has tried to prove is the nature of facultative reinsurance contracts, and the thesis adopted the view that reinsurers insure reinsureds’ liability undertaken by the latter under the original policy. The subject matter insured only forms the reinsurers’ liability and the reinsured has no insurable interest on the subject matter insured. However, the House of Lords in *Wasa* adopted the contrary view, although the law remains in part uncertain in England. Lord Mance found the warranty cases (*Vesta* and *Groupama*) exceptional and did not apply those cases to *Wasa*, whereas Lord Collins and Wilkinson found *Wasa* exceptional and did not apply the earlier cases where the applicable laws to the reinsurance and original insurance were different. In conclusion, now we do not know what the law is as for the interpretation of facultative reinsurance contracts. However it is clear from the decision of the House of Lords that reinsurance is not a liability insurance but a further insurance on the subject matter insured and the reinsured has an insurable interest on the subject matter insured by virtue of its original insurance contract. Where the law that will govern the original insurance cannot be identified at the outset of the contract, for instance where the original insurance provides a

Service of Suit clause, it is now possible for the reinsurers to argue that a foreign court interpretation of the original insurance policy may not be binding for an English reinsurer even though the policies provide identical cover with identical words.

APPENDIX

US REINSURANCE WORDING

FOLLOW THE FORM CLAUSES

- *Imperial Fire Ins. Co. of London v. Home Ins. Co. of New Orleans* 68 F 698 CA5 1895.

‘This policy to be subject to the same risks, conditions, valuations, indorsements, assignments, and mode of settlement as are or may be assumed or adopted by the HOME INSURANCE CO., and the loss, if any, payable pro rata, at the same time and in the same manner as by said company.’

- *Unigard Sec. Ins. Co., Inc. v. North River Ins. Co.* 4 F3d 1049 CA2 (NY), 1993.

“A. ... [T]he liability of [Unigard] shall follow that of [North River] and, except as otherwise provided by this Certificate, shall be subject in all respects to all the terms and conditions of [North River’s] policy except such as may purport to create a direct obligation of [Unigard] to the original insured or anyone other than [North River].”

FOLLOW THE FORTUNES / SETTLEMENT CLAUSES

- *Commercial Union Insurance Company v Seven Provinces* 9 F Supp 2d 49 D Mass, 1998 aff'd 217 F3d 33 CA1 (Mass), 2000

“[1] Being a reinsurance of and warranted same NETT⁷⁴³ rate, terms and conditions as and to follow the settlements of the EMPLOYER SURPLUS LINES INSURANCE COMPANY and that the local office of the said Company retains during the currency of this insurance at least \$225,000.00 BEING 50% OF \$450,000.00 EXCESS \$50,000.00 COMBINED SINGLE LIMIT ([2] subject to reduction by any general excess loss or excess catastrophe reinsurance whether effected by the head office or local office of the Company) [3] on the identical subject matter and risk and in identically the same proportion on each separate part thereof, but [4] in the event of the retained line being less than as above, Underwriter's lines to be proportionally reduced⁷⁴⁴.”

- *Unigard Sec. Ins. Co., Inc. v. North River Ins. Co.* 4 F3d 1049 CA2 (NY), 1993.

“D. All claims covered by this reinsurance when settled by [North River] shall be binding on [Unigard], who shall be bound to pay their proportion of such settlements. In addition thereto, [Unigard] shall be bound to pay (1) their proportion of expenses, other than [North River's] salaries and office expenses, incurred by [North River] in the investigation and settlement of claims or suits, and (2) their proportion of court costs, interest on any judgment or award and litigation expenses (provided their prior consent to legal proceedings has been obtained from the Underwriting Managers) as follows: (a) with respect to reinsurance provided on an excess of loss basis, in the ratio that [Unigard's] loss payment bears to [North River's] gross loss payment.”

- *City of Renton v. Lexington Ins. Co. (USA)* 2007 WL 2751356 WDWash.

There were two reinsurers, Lexington UK and Lexington US. Lexington UK reinsurance policy provided: “[t]his Reinsurance is subject to all terms, clauses and conditions as original except as provided herein, and to follow the settlements or other payments of whatsoever nature made by the Original Underwriters arising out of and in connection with the original insurance and to bear its proportion of any expenses incurred whether legal or otherwise in the investigation and defense of any claim hereunder.”

Lexington US policy states that : “[t]he liability of the Reinsurer shall follow the terms and conditions of the Company's policy furnished to the Reinsurer at the effective date of this Reinsurance Certificate unless otherwise specifically provided herein by endorsement made a part of this Certificate.”

⁷⁴³ The court clarified that this is a British spelling of “net” which means “net of commission paid to an agent or broker”.

⁷⁴⁴ The bracket numbers were not in the original text, the court added them.

- *Excess Ins. Co. Ltd. v. Factory Mut. Ins.* 3 NY3d 577, 2004.

“CONDITIONS: As original and subject to same valuation, clauses and conditions as contained in the original policy or policies but only to cover risks of All Risks of Physical Loss or Damage but excluding Inventory Shortage. ...Reinsurers agree to follow the settlements of the Reassured in all respects and to bear their proportion of any expenses incurred, whether legal or otherwise, in the investigation and defence of any claim hereunder.”

- *Travelers Cas. and Sur. Co. v. Constitution Reinsurance Corp.* 2004 WL 2387313, ED Mich.

“... The liability of the Reinsurer [CRC], as specified in Item 4 of the Declarations, shall follow that of the Company [Travelers] and shall be subject in all respects to all the terms and conditions of the Company’s policy except when otherwise specifically provided herein or designated as nonconcurrent reinsurance in the Declarations....”

“All loss settlements made by the Company, provided they are within the terms and conditions of the original polic(ies) and within the terms and conditions of this certificate of reinsurance, shall be binding on the Reinsurer. Upon receipt of a definitive statement of loss, the Reinsurer shall promptly pay its proportion of such loss as set forth in the Declarations ...”

- *Michigan Millers Mut. Ins. Co. v. North American Reinsurance Corp.* 182 Mich App 410, 1990.

“The liability of the Reinsurer shall follow the terms and conditions of the Company's policy [umbrella policy] furnished to the Reinsurer at the effective date of this Reinsurance Certificate....”

“F. LOSS PAYABLE. All insurance policy claims involving this reinsurance, when settled by the company, shall be binding upon the reinsurer, which shall be bound to pay its proportion of such settlements promptly following receipt of proof of loss in the following manner....”

- *Independence Ins. Co. v. Republic Nat. Life Ins. Co.* 447 SW 2d 462 Tex Civ App, 1969.

“Whenever a claim is made under a policy of the CEDING COMPANY which has been reinsured hereunder, whether the claim is under the strict policy conditions or under a compromise or otherwise, the settlement made by the CEDING COMPANY shall be unconditionally binding on the REPUBLIC NATIONAL.”

CLAIMS PROVISIONS

Notice of Loss Clauses

- *British Ins. Co. of Cayman v. Safety Nat. Cas.* 335 F3d 205 CA3 (NJ), 2003

“The Company shall advise Reinsurer promptly of any claim and any subsequent developments pertaining thereto which, in the opinion of the Company, may involve the reinsurance hereunder.... The Company, when so requested, will afford the Reinsurer an opportunity to be associated with the Company, at the expense of the Reinsurer, in the defense or control of any claim, suit or proceeding involving this reinsurance, and the Company and the Reinsurer shall cooperate in every respect in the defense and control of such claim, suit or proceeding.”

- *Travelers Indem. Co. v. Scor Reinsurance Co.* 62 F3d 74 CA2 (Conn), 1995.

Notice of Occurrence. The Company shall notify the Reinsurer promptly of any occurrence which in the Company’s estimate of the value of injuries or damages sought, without regard to liability, might result in judgment in an amount sufficient to involve this certificate of reinsurance. The Company shall also notify the Reinsurer promptly of any occurrence in respect of which the Company has created a loss reserve equal to or greater than fifty (50) percent of the Company's retention specified in item 3 of the Declarations: or, if this reinsurance applies on a contributing excess basis, when notice of claim is received by the company. While the Reinsurer does not undertake to investigate or defend claims or suits, it shall nevertheless have the right and shall be given the opportunity, with the full cooperation of the Company, to associate counsel at its own expense and to join with the Company and its representatives in the defense and control of any claim, suit or proceeding involving this certificate of reinsurance.

- *Unigard Sec. Ins. Co., Inc. v. North River Ins. Co.* 4 F3d 1049 CA2 (NY), 1993.

“C. Prompt notice shall be given by [North River] to the Underwriting Managers on behalf of [Unigard] of any occurrence or accident which appears likely to involve this reinsurance and while the Underwriting Managers or [Unigard] do not undertake to investigate or defend claims or suits, the Underwriting Managers, directly or through its representatives and/or counsel, shall nevertheless have the right and be given the opportunity to associate with [North River] and its representatives at [Unigard's] expense in the defense and control of any claim, suit or proceeding which may involve this reinsurance with the full cooperation of [North River].”

Right to associate / Claims co-operation clauses

- *Homan v. Employers Reinsurance Corp.* 345 Mo. 650, 1939.

“The corporation shall have the right *to participate jointly with the reinsured in investigation, adjustment and settlement of claims* upon which, in the judgment of the officers of the corporation, it is, or might become interested or exposed, and the reinsured agrees to cooperate with the corporation to the end that settlement may be made in each case where legal liability apparently exists, with a minimum of expense to the corporation.”

- *North River Ins. Co. v. Philadelphia Reinsurance Corp.* 797 F Supp 363 DNJO, 1992.

“The company [North River] shall furnish the Reinsurer with a copy of its policy and all endorsements thereto which in any manner affect this certificate, and shall make available for inspection and place at the disposal of the Reinsurer at reasonable times any of its records relating to this reinsurance or claims in connection therewith.”

ULTIMATE NET LOSS CLAUSE

- *Stickel v. Excess Ins. Co. of America* 136 Ohio St 49, 23 NE2d 839 Ohio 1939

“Section II. The term ‘ultimate net loss’ shall be understood to mean and shall mean the sum actually paid in cash in settlement of losses for which the company is liable, after making proper deductions”

ADDENDUM NO 5 in *Ott v. All-Star Ins. Corp.* 99 Wis 2d 635, 1981.

- “ADDENDUM NO. 5

“1. The following wording shall be added to the first paragraph of Article III
LIABILITY REINSURED :

‘Notwithstanding the foregoing it is also agreed that should the Company become legally obligated to pay a loss in excess of its policy limits the Reinsurer agrees to assume seventy-five percent (75%) of that part of such loss (plus proportionate loss expense) which is in excess of the policy limit. However, in the event the applicable policy limit is less than the Company's retention at the time of the loss, the amount hereby assumed by the Reinsurer shall be limited to seventy-five percent (75%) of that part of the loss (plus proportionate loss expense) which is in excess of said retention. In no event, however, shall the liability of the Reinsurer, respecting such loss, exceed the maximum amounts of liability set forth in the Exhibits attached hereto.’ ”

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“Access To Records Legal Issues Impacting Information Exchange between Cedent&Reinsurer”, by Peter Szendro/Kevin Mattessich, Presented at National Forum on Reinsurance Agreements, May 16&15, 2005, NYC.

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