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LONDON MARKET ISSUES: LEADERS, FOLLOWERS AND LAYERS

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Introduction

In the commercial insurance markets a single large risk may be divided between different insurers, each insurer taking only a share of the total, with several liability only (the subscription market). Or the risk may be divided into several layers above a retention, with a different insurer (or insurers) on each layer. For the convenience of insured and insurers in the subscription market it is common for one or more insurers to undertake administrative functions on behalf of, or for the benefit of the others.

This article discusses the relationship between leading and following underwriters generally; next it describes the operation of the new Lloyd's claims scheme; finally, it analyses the relations between the insurers on different layers in a vertical programme or "tower".

Leaders and Followers

Where a risk is placed in the London subscription market, whether at Lloyd's or in the company market, the slip is likely to confer on the leader functions in relation to determining the precise wording of the original contract, any subsequent endorsements, and the settlement of claims. Questions arise from time to time as to the authority of the leader to bind the following market at each stage, any duties owed by the leader to the following market, and the effect on the following market of material misrepresentations or non-disclosure by brokers in their dealings with the leader.

A leading underwriter agreement may be an ad hoc clause in the slip or a standard form market agreement incorporated into it by reference. Since October 2001 the LMP (London Market Principles) General Underwriters Agreement (GUA), produced for use with the LMP slip and subsequently the standard form Market Reform Contract (MRC), has replaced the earlier LUA/ILU market agreements in the London market. It incorporates, as appropriate, schedules for use by the different markets, ie non-marine, marine cargo, marine hull etc.[2] But the GUA is not in universal use so it is necessary first to consider questions that have arisen under less comprehensively drafted arrangements.

Purpose and scope of leading underwriter clauses

A leading underwriter clause may give the lead underwriter the power to agree the original wording or terms of the policy (eg "wording tba L/U") so as to bind the followers, although this will be much less common now that, in the London market, the Contract Certainty Code of Practice (and the use of the MRC slip) requires "the complete and final agreement of all terms between the insured and insurer by the time that they enter into the contract, with contract documentation provided promptly

thereafter." O'Neill and Woloniecki, in *The Law of Reinsurance*,[3] take the view that contract certainty would still allow a leader and a follower to sign a slip with wording to be agreed by the leader alone, but the leader's agreement of the wording would have to be given before the date the contract came into force, ie the signatures of the leader and follower took effect subject to that condition subsequent.

Does the leader have power to agree wording which includes an arbitration clause not mentioned in the slip? In *Unum Life v Phoenix Israel*[4], Mr. Justice Andrew Smith held not,[5] relying on authorities involving the incorporation (or not) of arbitration clauses where general words had incorporated by reference the terms and conditions of retroceded contracts or lower layers of cover. Those cases had followed a line of authorities on the incorporation of charterparty arbitration clauses into bills of lading. In the Court of Appeal, however, Lord Justice Mance took the view[6] that the incorporation cases had little, if anything, to do with the scope of a leading underwriter's authority to bind the following market. He would have given leave to appeal on the point if the followers had not already terminated the leader's authority by avoiding the contract by the time he got round to agreeing the wording.

A leading underwriter clause normally gives the leader power to agree endorsements, extensions, changes in conditions etc. The clauses can be wide in scope. In *Barlee Marine Corp v Mountain ("The Leegas")*[7] the leading underwriter clause provided:

> "Any amendments, additions, deletions, including new and/or acquired and/or managed and/or chartered, notices of assignment, ratings and alterations of any description to be agreed by Leading Underwriter and to be binding on all others hereon".

In that case extensions of a marine war risks policy granted by the leader were attacked by the followers on the ground that they purported to convert what was intended to be a policy covering 8 voyages over 4 months to 20 voyages over 8 ½ months. Market understanding was said to be that the purpose of the leading underwriter clause was limited to minor or immaterial amendments: a wider construction would permit infinite variation by the leading underwriter, the granting of indefinite time limit extensions or even converting it into an aviation policy. Mr. Justice Hirst rejected this *reductio ad absurdum*. He held that the clause was limited by the "Type" of cover afforded by the policy, viz "Marine – Hull etc War". Followers would not be saddled with infinite extensions because they could always have recourse to the termination clause. "Underlying the whole relationship between the leading underwriters and the following underwriters is the former's manifest duty of care. In any event, the task before the Court is not to lay down a construction which will cover any possible eventuality, but rather to decide whether the extension and alterations in fact agreed to by the leading underwriter are within the scope of the leading underwriter clause."[8] He held that they were.

A clause of even wider scope was considered in *Roadworks (1952) Ltd v Charman*[9] :

> "All alterations, additions, deletions, extensions, agreements, rates and changes in conditions to be agreed by the Leading Lloyd's Underwriter and Leading Company Underwriter only. Such agreement to be binding on all Underwriters subscribing hereon."

It was held to confer authority on the leader to waive a condition requiring Salvage Association approval of beaching arrangements prior to the beaching of a barge.[10] The Salvage Association had said it could not approve the beaching in view of the many unknowns regarding the seabed. The broker and the underwriters had not used the Leading Underwriter Agreement General Marine (LUAGM) clause on the slip, which would have incorporated a code identifying the leaders and specifying their authority and limiting it to alterations "which in the judgment of those leading underwriters do not constitute a material alteration to the risk".

Leading underwriter clauses may sometimes also allow the leader to bind the followers as to the settlement of claims: see *Roar Marine v Bimeh Iran*[11] and T*he Buana Dua*[12], below.

Identification of leader

The leader will normally be appointed or identified[13] as such in the slip. If there are two slips, eg one Lloyd's and one company market, there may then be two leaders, or one of them may be identified as leading London underwriter. If there is no specific appointment, the leader will have to be identified by inference from the circumstances. Relevant indicia may be: the order in which underwriters scratch the slip (notwithstanding that he may have taken only a 5% line in contrast to a 20% line taken by one of the followers); any assumption by an underwriter of the role as leader, such as agreeing or purporting to agree an endorsement in that capacity; or a reference in the broker's cover note to a particular underwriter as leader.[14]

Agent or trigger?

Debate has arisen whether the leading underwriter clause in a slip scratched by each follower confers on the leader authority as agent to act on behalf of the following market or operates as an agreement between followers and the assured to be bound by what the leader does. On the latter analysis an endorsement agreed between assured and leader would act as a "trigger" to a change in the agreements between the assured and the followers. In *Roadworks* v *Charman* His Honour Judge Kershaw QC, sitting as a Deputy Judge of the Commercial Court, held that the leader acts as agent of the following market: by taking a line they not only contract with the assured but also make the leader their agent for the purpose shown in the leading underwriter clause.[15] That purpose included waiving a contingent condition as to the survey arrangements for the beaching of the insured barge.

In *Mander* v *Commercial Union*,[16] however, Mr. Justice Rix tentatively suggested that, at least under a facultative open cover, the leader is not constituted an agent of the

following market by the leading underwriter clause. The better view was that by subscribing to the cover the followers agree to be bound by a declaration to the cover agreed by the leader, the agreement by the leader to the declaration acting as a "trigger" rather than an act of agency. This analysis, in the judge's view, avoids imposing on the leader the unrealistic fiduciary obligations of an agent (such as the duty to avoid conflicts of interest). Moreover, since the terms of the open cover are there for all to see, there can be no reason to think the leader makes representations about the scope of the leader's authority that might give rise to actions for breach of warranty of authority on his part.

The assured itself is never expressed to be a party to any separate subscription agreement between the underwriters.

Leaders' duties of care to followers

In *Roadworks* v *Charman* (mentioned above) the judge, without expressing any concluded view on the point, envisaged the possibility that in exercising power under a leading underwriter clause the leader might owe a duty of care to the followers. Such a duty might arise from an implied term in a contract of agency or exist independently of contract.[17]

As regards the initial underwriting, there is generally a defined potential class of following underwriters who the leader knows may well rely on his expert judgment in rating the slip and deciding its terms and conditions. It is, however, not at all clear that he can be said consciously to assume functions in relation to them sufficient to create a duty of care to them. The leader might be writing or rating the contract influenced by all kinds of considerations, such as the availability of reinsurance or the desire to get other business from the broker, and the followers will realise this. By way of analogy, in *Bonner* v *Cox*[18] underwriters negligently underwrote an open cover, ceding severely loss-making business under their reinsurance, but it was held that they owed no duty of care to the reinsurers in the way risks were selected and underwritten.[19]

Once a leader has authority under a leading underwriter clause, however, he is aware that the class of followers rely on his judgment, having given him the authority (or at least, on the "trigger" view, the power) to agree endorsements which they will not have the opportunity to consider for themselves. In that context, as Mr. Justice Hirst put it in *The Leegas*:

> "Underlying the whole relationship between the leading underwriter and the following underwriters, furthermore, is the former's manifest duty of care".[20]

In the context of a claims agreement clause Mance J considered in *Roar Marine v Bimeh Iran* that the existence of such a duty of care was likely.[21]

There is, however, no mention of any duty of care in the GUA or its antecedent market agreements.

Termination of leader's authority

Can the authority of the leader (or power, depending on whether one takes the agency or trigger view) be terminated? In *Unum Life* Mr. Justice Andrew Smith declined to hold that there was an implied term that it expires by effluxion of time.[22] He was also satisfied that it was not usually the case that a leading underwriter provision would be revocable, but he accepted the force of the argument that the wider the scope of the leader's authority, the stronger the argument that it would be revocable, at least on notice.[23] This would accord with the general principle that an agency is always revocable (even if revocation constitutes a breach of the agency contract) unless coupled with an interest or in certain other special circumstances. The leader might well continue to have ostensible authority until the assured or its broker was given notice of the revocation.

In *Unum Life* the judge at first instance and Lords Justices Mance and Keene on appeal had no doubt that the agency had been terminated by the follower's avoidance of the reinsurance for non-disclosure of material facts.

Disclosure and representations by the broker to the leader

In *The Zephyr*[24] Mr. Justice Hobhouse held, at first instance, that the broker owed a duty of care in tort not only to the leading underwriters to whom "signing" indications were given, and to the members of their respective syndicates, but also to the syndicates to whose underwriter (Mr Posgate) no express signing indication had been given. This was on the footing that, knowing the particular broker as he did, it was reasonable for Mr Posgate to assume that the broker would follow his usual practice of obtaining substantial oversubscription. A sufficient proximity arose as regards the following syndicates because the broker knew, or ought to have known, that the following underwriter, Mr Posgate, would rely on the broker's judgment as well.[25] But Lord Justice Mustill held, on appeal, that the brokers owed no such duty of care to the Posgate syndicates. Unlike the judge at first instance, he would have been prepared to hold that the signing indication gave rise to a contractual relationship between the broker giving it and those underwriters to whom it was given. He was not prepared to find that failure to perform a positive undertaking could give rise to an action in the tort of negligence, as opposed to in contract.[26] That conclusion now seems questionable in the light of *Henderson* v *Merrett*,[27] applied to insurance brokers by *BP* v *Aon*[28] and *HIH* v *JLT*,[29] in which brokers were held liable in tort for failure adequately to perform functions assumed by them, independently of any contract.

In *The Zephyr* Mustill LJ also doubted the supposed earlier rule that a misrepresentation made to the leader of such a character as to entitle the leader to avoid the insurance is effective to give a similar right to the followers.[30]

However, followers may have a remedy. *Aneco* v *Johnson and Higgins*[31] was a case in which brokers were sued for negligence in placing a risk on behalf of their client in such a way

that the retrocessionaires were entitled to avoid it for misrepresentations or non-disclosures to the leaders and the followers. The brokers had misrepresented to the leaders the nature of the underlying reinsurances. The arbitrators who had declared that the retrocessionaires were entitled to avoid the contracts observed that the avoidances by the followers could also have been based on an (untrue) implied representation by the brokers to each of the followers that the risk had been broked fairly to the leader(s) on the slips, which had induced the followers to subscribe to the risk.[32] Mr. Justice Cresswell, at first instance, held, explicitly on the basis of expert evidence of practice in the Lloyd's marine market in late 1998/early 1999, that the fact that in broking the retrocession contracts the broker had (negligently) misrepresented to the leader(s) the nature of the underlying reinsurance was a material circumstance which the brokers were required to disclose in order to make a fair presentation of the risk to the followers. There was a presumption in the case of those followers who had not given evidence that they had been induced by that non-disclosure to enter into the contracts.[33] This aspect of the judgment, which was not overturned on the subsequent appeal,[34] has since been followed in several cases.[35] In relatively specialised business there may be a greater degree of reliance by the followers on the leader's judgement (and therefore on broker's presentation to him) than in more general business.

In *Sirius* v *Oriental* [37], a decision to the contrary, the point does not appear to have been fully argued, and Mr. Justice Longmore found that there had in fact been no inducement.

Claims settling authority

Leading underwriter clauses do not confer claims settling authority unless they expressly so provide. In the absence of a clause giving the leader claims settlement authority, or a "follow the leader provision" in relation to claims, an arbitration award or a judgment against the leader does not bind the followers.[38] Nor are the followers entitled to see the award, even though it might be commercially persuasive in pending proceedings involving them, unless the rights of one of the parties to the arbitration can be protected or enforced only by disclosure of the award to the follower.[39]

Where leading underwriter clauses do confer claims settling authority, or there is a "follow the leader" clause, the courts construe them generously, having regard to their obvious commercial purpose of simplifying administration and claims settlement - *Roar Marine v Bimeh Iran*[40], followed in *The Buana Dua.*[41] So the courts will not imply a term into leading underwriter clauses that the settlement must have been concluded in a proper and businesslike way, by analogy with "follow the settlements clauses" in reinsurance contracts.[42] Nor will they exclude from the ambit of the clause losses alleged by the followers to be "outside the cover" because not perils insured against (eg wear and tear rather than crew negligence),[43] or because there is alleged to have been a breach of a warranty, so that the loss does not fall within the leader's authority to make "… settlements *within the terms of the policy*".[44] The followers will not be allowed to reinvestigate the factual

cause where they contest the view of the leader[45] or, in the absence of the clearest words, argue that they are bound only as to quantum and not liability.[46]

In *Roar Marine* Mr. Justice Mance, without expressing a concluded view, considered it likely that in exercising his authority to bind them as to claims settlement the leader owed a duty of care to the following market: he doubted whether the leader's duty differed from that considered by Mr. Justice Hirst in *The Leegas* as "manifest".[47]

Leaders and followers: General Underwriters Agreement

The scope for uncertainty or disputes outlined above is significantly reduced where the General Underwriters Agreement (GUA) is used in conjunction with the MRC Slip. The MRC is now compulsory for most Lloyd's business, except where the client otherwise requires.[48] Because the Contract Certainty Code of Practice require the complete agreement of all terms before the contract is entered into, the GUA assumes that the initial wording is already agreed, and so confers authority only as regards amendments, not the initial wording, and does not cover claims.

The "Subscription Agreement" section of a duly completed MRC slip identifies the Slip Leader. It specifies the basis of agreement for contract changes (eg "GUA 2001 with Non-Marine Schedule"). It identifies the "Agreement Parties" for contract changes which are to bind the whole market on the slip, and those who are to agree changes for their own proportion only.

The Subscription Agreement of a duly completed MRC slip specifies the "Basis of Claims Agreement", eg Lloyd's Claims Scheme (Combined) and IUA claims agreement practice, and identifies the "Claims Agreement Parties ", eg "Slip Leader plus insurance company and Scheme Service Provider".

The GUA provides that the terms of the slip override it where inconsistent.

Notwithstanding the possible advantages of the "trigger" theory, the GUA unequivocally constitutes the leader the agent of the followers for the purpose of agreeing post-placement alterations (but not settling claims). It says nothing about any duty of care owed by the leaders to the followers.

The Slip Leader alone and the Slip Leader together with the other Agreement Parties (if any) are given the powers to amend the contract set out in detail in Parts 1 and Parts 2 respectively of the appropriate Schedule for the class of business in question (specified in the subscription section of the slip). Part 3 of the relevant Schedule specifies in detail types of alteration to the contracts (ie the several insurance contracts with each "Underwriter") that can be agreed only by those Underwriters themselves.[49] "Underwriter" is not defined but appears, as in many other generic market documents, to include the members of a Lloyd's syndicate taken together, acting through the underwriter employed by the syndicate's managing agent. A GUA stamp is to be applied to, if it is not already incorporated in, any endorsement presented for agreement, initialled in the appropriate box so as to indicate which Agreement Parties have authority to agree the endorsement.[50]

Where there is any conflict the slip and any endorsement override the GUA, "provided that they have been shown to and agreed by each[51] subscribing Underwriter for its own proportion". This enables adaptation of the Schedules to confer agreement authority otherwise than contemplated by the schedules.[52]

An alteration agreed by Agreement Parties is to be notified to the other Underwriters if the Agreement Parties so require, or where required by the slip or by Part 1 or 2 of the relevant schedule to be notified or "listed" to other Underwriters.[53]

There are provisions for the replacement of the Slip Leader in certain circumstances such as insolvency, withdrawal of regulatory permissions, or going into run-off.[54] The delegated authority can be terminated by an Underwriter at any time with effect from the date of giving notice to the broker, but not so as to affect accrued rights of that Underwriter or the assured as regards alterations already agreed.[55] The authority will be automatically terminated where the Underwriter is subject to an insolvency or similar procedure or has regulatory permission withdrawn for the relevant class of business.[56]

The GUA is an agreement between the subscribing insurers themselves but is not expressed to be an agreement between them severally and the assured, who is, however, assumed to have rights as regards the GUA under the Contracts (Rights of Third Parties) Act 1999.[57]

Lloyd's Claims Schemes

Since 1991 Lloyd's has required managing agents and their syndicates to participate in a series of claims schemes which apply when two or more syndicates underwrite the same risk (except where managed by the same managing agent). The claims schemes have simplified the administration and settlement of claims by focusing those functions on one or more lead underwriters and a claims office.

2010 Claims Scheme

Under the 2006 Claims Scheme, notwithstanding any agreement on the slip or elsewhere scheme claims were to be determined by the leader on behalf of his own syndicate and by a "scheme service provider" (approved by the Franchise Board and authorised by a contract entered into with each relevant managing agent) on behalf of the followers, following appropriate consultation between them. A new scheme, the 2010 Claims Scheme, is being introduced in phases at specified dates for claims made under policies with specified risk codes incepting (or policies written under binding authorities incepting) on or after those dates.[58] It is intended that all risk codes should be covered after 1 July 2012. The timing of its introduction for legacy claims (ie those under policies incepting before the specified dates) is under consideration.

The 2010 scheme applies only to claims notified by electronic claims file (ECF).

The key features of the 2010 scheme, from January 2012, are as follows. Claims are categorised into "standard" and "complex" claims, the latter being (broadly) claims

potentially not less than specified amounts (£250,000 except for £500,000 for energy and property treaty risks) for given risk codes or claims that are likely to be difficult to resolve, including claims subject to dispute resolution proceedings.[59] The managing agent of the lead syndicate "triages" the claim, determining whether a claim is a standard or a complex claim.[60] The managing agent of the lead syndicate can initially assign,[61] or subsequently reassign,[62] a standard claim as a complex claim if it considers it appropriate, having regard to guidance given by Lloyd's from time to time;[63] and the managing agents of the lead and second syndicates may reassign a complex claim as a standard claim if they both think it appropriate.[64]

"Standard claims" are determined by the managing agent of the lead syndicate alone on behalf of the following syndicates;[65] "complex claims" are determined by the managing agents of the lead and second syndicates in agreement with each other,[66] on behalf of the following syndicates.

The managing agent of the lead syndicate may delegate its claims handling authority to another person provided that the delegation is properly documented and is notified to the following syndicates and any relevant Lloyd's broker. The managing agent of the second syndicate can delegate its claims settling authority only to Xchanging Claims Services (XCS) or another scheme service provider authorised by the Franchise Board (except where , as a managing agent of a leading syndicate it has already delegated claims handling to another person, in which case it can again delegate to that person).[67]

In each case the lead managing agent, and the managing agent of the second syndicate, if involved in determining a complex claim, are required to exercise the reasonable care of a reasonably competent managing agent.[68] The liability of each to the followers is limited in aggregate to £2m in respect of any one 2010 scheme claim and £10m in respect of all such claims made in any one calendar year.[69]

On receipt of a 2010 scheme claim the managing agent is to take appropriate steps (usually by ECF) to inform the managing agent of the second syndicate, and to provide the claims information it has received, if it is a complex claim;[70] and in every case to inform the followers of receipt of a 2010 scheme claim.[71]

Where a managing agent is required to act on behalf of following syndicates under the 2010 Claims Scheme it is obliged to act in the best interests of all those syndicates on whose behalf it acts. If it concludes that it cannot do so (presumably because of a conflict of interest) it must notify the managing agents of the followers and the managing agent of the next syndicate in slip order shall take its place for the purpose of the scheme.[72]

The followers have various rights to be involved. All relevant documents and comments should be on the ECF. Proposed ex gratia settlements, commutations and rescissions must be referred to the followers for agreement.[73] Professional advisers' reports are to be sent to the followers,[74] and in the case of complex claims subject to dispute resolution proceedings simultaneously to the leaders and any follower(s) so requesting. The leader(s)

are required to notify the followers as soon as practicable of recommended reserves for a claim, any revision of recommended reserves, the receipt of notice of dispute resolution proceedings, and the delegation of claims determination to another person under paragraph 10 of the 2010 Claims Scheme. A following syndicate's managing agent may request the leader(s) to provide such further information as it may reasonably require.[75]

Where the leader and the managing agent of the second syndicate disagree as to the handling of a claim they are to use best endeavours to resolve their difference and if they are unable to so, to convene a market meeting of the followers to attempt to achieve a consensus.[76]

Detailed procedures as to the leader's proactive handling and communication of claims, establishment of reserves and appointment of third party experts are set out in guidance by Lloyd's.[77]

Excess Layers

There has been little decided case law on issues relating to layers in England; nor is there any overriding or binding market practice to provide answers. One is therefore left to rely on basic principles, analogy with other legal areas, and in the last resort, a fair dose of conjecture. The following discussion approaches the subject from a practical and personal stance to reflect the issues that one of the authors (JLC) has encountered as a practitioner.

There seem to be seven main problem areas, often interconnected.

(i) *Inconsistency in wordings between layers*

The primary layer provides the first layer of coverage that attaches upon an occurrence covered by the terms of the policy. Excess insurance is written to apply to an insured's loss after the primary is exhausted (or the wording might instead refer to the underwriters of the underlying policies having paid or admitted liability or having been held liable to pay the full amount of their indemnity).

The excess layer may "follow the form" of the underlying coverage or be written on its own insuring agreement. A typical clause might be

> "[e]xcept as stated to the contrary, this policy shall be subject to the same terms, exclusions, conditions and definitions as the primary policy".

Sometimes, an excess policy may be created unintentionally, in which case one would expect no reference to other layers.

Generally, the policies will dovetail. If not, there may be issues, as in the recent *Teal v W R Berkley*[78] case where the excess policy at the top of the tower did not cover claims arising in the USA, unlike the policies lower down. That difference was unintentional but differences may also be intentional For example, with solicitors' professional indemnity, the primary will be subject to the Solicitors' Regulation Authority Minimum Terms and Conditions and the primary will have contracted out of the right to avoid for material

misrepresentation and non-disclosure. The excess layers, however, may not be so constrained and indeed any excess policies are likely to state specifically that such conditions shall not apply.

There appear to be two reported cases in which inconsistencies between layer wordings were raised. The first was the first instance preliminary issue decision of Mr. Justice Moore-Bick in *Friends Provident v Sirius;*[79] the point was not live in the Court of Appeal, but Lord Justice Mance said he entirely concurred with what the judge had said.[80] The second was *Dunlop Haywards v Barbon.*[81]

In *Friends Provident* the question was whether the cover provided in the excess layer policies included General Condition 2 of the primary layer policy although it was not specifically included in the excess layer wording. The clause required that notice be given to underwriters as soon as possible of circumstances that might give rise to a loss, but also provided for extension of cover to claims arising after the policy period from circumstances notified to underwriters during the policy period. The excess layer policies provided that they were subject to the same terms as the primary layer policy.

Expert evidence of market practice was that, in the absence of any indication to the contrary, it is generally assumed that the scope of cover provided under the excess layer is intended to be the same as that provided under the primary layer (apart from policy limits). While a material difference in the scope of the two might not render the cover wholly unworkable, an insured would bear a greater part of the risk if the scope of the cover were more limited than under the primary.[82]

The judge held that the cover extension clause supplemented rather than contradicted the insuring clause and was consistent with the express terms of the excess layer policies. Indeed, there were strong grounds for concluding that the parties intended to incorporate the extension of cover, since a failure to do so would mean that the insured would, as regards the excess layer policies, be unable to recover during any policy period where claims arose from circumstances of which it became aware during one policy period but were not made until a later policy period.[83]

He held that the usual starting point when deciding whether a clause can be effectively incorporated by reference is to construe it as if it were written out in full in the contract into which it is said to be incorporated. It will then become apparent whether it makes sense in that context (with or without an acceptable degree of verbal manipulation) and whether it is inconsistent with other clauses in the contract.[84]

The judge also had to decide whether the condition of the cover extension clause (as incorporated into the excess layer policies) that notice of circumstances be given to underwriters required that notice be given to the excess layer underwriters as well as to the primary layer. He held that the term "the underwriters" in the cover extension clause, for the purpose of the requirement to give notice of circumstances to the underwriters, meant the underwriters on the primary layer even when read in the context of the excess

policies. Further, it required little manipulation for "this policy" in that clause to refer to the excess layer policies into which that clause, as a whole, had been incorporated.[85]

In *Dunlop Haywards* (mentioned above), where cover was in two layers, a primary of £10m and an excess layer of £10m over £10m, the primary layer accepted claims (lenders' claims based on negligent or fraudulent valuations) up to the limit of indemnity but the excess layer rejected the claims, on the basis that excess cover was limited by the policy wording to the group's property management activities only. The brokers were sued and excess layer was joined.

It was held[86] that as a matter of ordinary language there was a clear distinction between "property management" and "property valuation", a distinction well recognised in professional indemnity. As a matter of construction, the excess did not cover the valuation claims. The claim for rectification failed. The common intention was to provide cover for commercial property management activities alone.

(ii) *Relationship/duties between layers*

The starting point in any discussion is that there is generally no contractual relationship between the primary layer insurer and the excess layer insurer of a common insured that would lead to contractual duties between them. Even though the contracts may cover the same subject matter, the primary and excess are strangers to each other's contracts. Insurance contracts create rights between the insured and the insurer, not between co-insurers.

It seems highly unlikely that any court would impose a direct tortious duty of care on the primary layer towards the excess layer**.** So, although there is no authority on the point, it seems unlikely that there is any liability on a primary layer who mishandles a claim in such a way that the loss is actually increased or who fails to take an opportunity to settle within its layer so that the excess layer has to pay.

From first principles it seems that a court would find it very difficult to find a duty of care. It is the responsibility of each layer to ascertain whether the loss falls within its terms and layer. In practice the excess will probably have had the opportunity to make representations, for example, in market meetings; it may have its own legal representation; and while it may be easy to be wise after the event, a court would probably take the view that it is not fair and reasonable to impose a duty and second guess how better the primary could have handled the claim. The excess layer has no legitimate expectation that the primary layer will give as much consideration to the excess layer's interests (as a stranger to the contract) as to its own or to the insured's interests.

What possible contrary arguments could there be?

a. USA position

In the USA there is much more decided law and the question arises whether any of the same logic could be applied here? Claims brought by excess layers against primary seem not uncommon in the USA, not that they always succeed.

It is often said in the UK that in the USA, or in some jurisdictions there, the primary does owe a distinct duty to the excess. This is not quite correct. So far as one of the authors (JLC, not US qualified) understands it, it is only in New York, and possibly Florida, that the courts have held that an excess insurer may maintain a direct action against the primary.[87] Generally, the courts are most conservative and the majority of states do not recognise a cause of action in tort against the primary in the absence of contractual obligations (see for example *Federal Ins. Co. v Travalers Casualty & Surety Co.*[88]). In the majority of states the courts hold that the excess layer's rights, if any, against the primary arise through the doctrine of equitable subrogation, which is derivative from the primary's duty to the insured. So if an excess pays off a tort claim by a third party in excess of the primary's limits and then takes an assignment from the insured, the excess is subrogated to the insured's right to sue the primary carrier for actions in bad faith against the insured.

This may be of limited significance. Where the insured has consented to the settlement or where the insured's assets are not put at risk (perhaps even because there is sufficient excess insurance), excess insurers may be barred from proceeding against the primary, since the excess can be in no better position than the insured. Equally if the excess layer steps in and pays the settlement to prevent it reaching an even larger loss the majority of courts have said that there is no cause of action.

Of course, in the USA duties owed by the insurer to the insured are much more developed in the sense of the availability of bad faith damages, and the insurer's duty to defend. But even given this, could this subrogation reasoning be exported over to England? We shall deliberately leave this as a question and simply mention that if our own law on insurers' duties to the insured were to become more defined, for example, with the adoption of the current Law Commission proposals, it might come be seen to be more of a realistic possibility.

b. Assumption of responsibility under existing English law?

Might an English court, on the special facts of any particular case, consider that the primary layer had voluntarily assumed a specific responsibility towards an excess layer ?

A possible example might be where an all-market steering committee has agreed that the primary will act for the rest of the market and in this case there may be an assumption of responsibility or even agency, so that failure by the primary layer claims handler to pursue a subrogated claim within the limitation period might render the primary layer liable to the excess layers.

c. Unconscionable behaviour or dishonesty?

There are judicial comments in cases dealing with other legal situations where there is clearly no contractual or other duty – and also in the USA - along the lines that

if there has been bad faith or collusion, the position might be different - see for example the suggestion in *Normid Housing Association v Ralphs*[89]. Thus, if a settlement is reached which impacts on the excess and which involves concealment, duress, fraud, mistake, unconscionable conduct, or similar irregularity, would a prejudiced excess be able to claim some sort of fiduciary relationship? It is difficult to see how the primary could find itself in the position of a fiduciary. Presumably, any settlement obtained by fraud would not bind the excess in any event - for example if a primary and insured acted collusively to allocate certain dates to claims to maximise the excess's liability.

(iii) *Excess layer insurers: "going it alone" and influencing events*

Can excess layer insurers act differently from the rest of the market and to what extent do they have an influence?

Taking policy coverage first, there is nothing to stop an excess insurer coming to a genuinely different view from the primary: an excess might just want to pay its limits and get out.

It is more difficult where a third party claim is in progress and the excess layer wants to adopt a different strategy from the primary. This is where one probably sees the most issues in practice. Not surprisingly, the stance taken by the various parties tends to depend on where their attachment point is.

Generally, there will be no agreement in place to govern whose views should prevail. In the absence of such an agreement, there appears to be no legal rule (or market practice) that a primary has to consult or have regard to the interests of the excess as regards strategy on the claim or as regards settlement, although they may do so in practice particularly if the market wants to be seen to be acting in a united way.

Equally, unless specifically agreed beforehand or there are some other special circumstances, the primary does not have authority to agree to settle a claim so as to bind the other layers.

If the excess layer wants to influence events, this is generally achieved by negotiation or commercial pressure and via the applicable claims control clauses. Where there are differences of opinion, excess layers are likely to have their own legal representation and they will certainly do everything they can to exert any commercial muscle they might have.

Any claims control clause in the primary policy is likely to mean that the insured will have to do the bidding of the primary layer in the defence of the third party claim, which will effectively give the primary control over strategic decisions – in other words, via the insured. The excess layer is likely to have seen the claims control clause in the primary, or have had the opportunity to see it, when writing the risk and so would be ill-placed to complain.

Claims control clauses in the excess wording may also be relevant. The excess wording will probably contain a clause specifying that the insured cannot agree to settle without their

consent. The excess layer insurers should be able to utilise such a clause, at least in negotiation, by trying to ensure, via the insured, that the unwanted settlement is blocked.

One excess layer wording which one of the authors (JLC) has seen, states that excess may make a full and final payment to the insured of the indemnity limit or of any lesser sum for which the claim can be settled. It goes on "*provided that if the Underlying Policy(ies) refuse to agree to any such settlement, Insurers may require the Insured to exercise all rights available to the Insured under the Underlying Policy(ies) not to be required to contest the claim"* (…). The insured is therefore under a duty to the excess insurers to be as "awkward" as it legitimately can be with the primary (and in that clause, exercising all its rights under the QC clause).

(iv) *Dropping down*

It appears, depending of course on the wording, that liability under an excess policy only attaches once the primary has been exhausted. The excess layer may, however, provide in some cases that it is to "drop down" to take the place of the primary layer once (or to the extent that) the primary layer is exhausted.

A typical drop down clause might be as follows:

> "(a) In the event of partial exhaustion, this Policy will apply in excess of the remaining balance of the Underlying Limit(s) of Liability; and
>
> (b) In the event of total exhaustion, then this Policy shall continue in force as the underlying."

There have been two recent cases in England on drop down: *Flexysys America v XL*[90] in 2009 and *Teal Insurance v W R Berkley*[91] in 2011.

In *Flexysys*, a master policy was supposed to drop down to provide coverage that would have been available under a local policy. However, the clause had no application to a claim which while it exceeded the limits of the local policy, fell outside the terms of the master policy.

In *Teal* there was an attempt to engineer the order in which claims were paid from a PI tower so that a reinsurance recovery could be made in circumstances where the top layer excess policy (and its reinsurance) excluded USA claims – unlike the policies further down. The Court of Appeal held that claims under the policies had to be allocated in the order in which losses were suffered by the insured, based on the date on which its liability was established and quantified in respect of each claim against it.

The other point that seems clear, although not from any of these cases, is that an excess does not drop down where an insurer on the layer below becomes insolvent. An excess is not a guarantor of the solvency of the primary layer. However, if one had a clause providing for liability in excess of sums "actually recoverable" from the primary that might open the way for a drop down in those circumstances.[92]

One issue that could also provide problems is where a sublimit only is exhausted (say on regulatory expenses); does the excess drop down at all, in part or what? The wording would have to be looked at very carefully.

(v) *Notification to excess layers*

The excess layer will normally provide for notification by the insured and this can often be in the form of a condition precedent.

It is clear that the primary does not owe any general duty to the excess to notify. The primary is not the notification agent to excess layer insurers – *Tioxide v CGU.*[93]

In *Sirius v Friends Provident*, however, the Court of Appeal held that notification to the primary was deemed to be notification to the excess as a result of the incorporation into the excess policy of the notification provision in the primary, irrespective of the actual state of knowledge of the excess.

An insurer may be on more than one layer (in both *Sirius* and *Dunlop Haywards*, the primary was also on a higher layer too) and have notice in one capacity but not the other. There is no case law as to the effect of this. However, it would most likely be argued that if an insurer had actual knowledge of a claim through being on another layer, it ought to be precluded from taking policy defences that would otherwise have been available. This might be thought to produce anomalous results if the other insurers on the same excess layer were held not to have notice.

(vi) *Sharing/obtaining information*

This, particularly the provision of legal and other expert reports, is quite a common, and contentious, issue in practice.

The important point is that no duty is owed by the primary to provide information to the excess.

The excess layer contract may impose a specific duty on the insured to provide information to the excess or the excess might try to rely on a term incorporated from the primary. However, the excess insurer is likely to be able to obtain information and cooperation from the insured only insofar as it specifically relates to that insurer's layer (for example to investigate the claim, determine his liability and to exercise his rights under the policy to defend the claim): so the excess layer probably cannot expect that the insured should provide it with exactly the same information as he (the insured) provides to the primary, which would be needed for the purposes of defending the third party claim.

The excess has no automatic right to see legal reports. If the excess is contributing to the lawyers' costs on an ongoing basis, that would be a matter for agreement.

One issue that seems to be quite common at the moment is the primary who obtains a draft report and will only let excess see a final or edited version. Subject to the precise arrangements agreed beforehand and subject to how fees are being paid for, the primary

layer is probably within its rights to refuse to hand over drafts or the original version. The excess could equally well obtain a lawyer's opinion of its own.

Insurers should consider the question of maintaining common interest privilege before releasing any advice. They also need to be alive to data protection and other confidentiality issues. If an insurer on one layer is given confidential information, and he is on another layer too, he cannot release information to others on that layer and indeed he may have difficulties using that information himself in any other capacity from that in which he is given it.

(vii) *Sharing costs and recoveries*

Sharing of costs and recoveries may be dealt with in the excess wordings or by subsequent agreement. Alternatives include:

a. The primary pays the costs of defending the claim (with perhaps an accounting process at the end of the day)

b. The costs will be shared pro rata between all layers that are ultimately impacted by the claim according to their shares or respective ultimate liabilities

c. The costs are shared equally or according to other fixed percentages.

Generally there will be a condition in the excess that no costs are payable without consent.

In the absence of agreement, there is no market practice or quantum meruit type of rule to govern the situation. Costs apportionment is generally dealt with on a commercial basis as to what seems workable in the circumstances. Often costs issues are left over until the end of a matter with a final reckoning to come. This can be the only solution where, for example, it is not known how many claims there will ultimately be. But it does cause issues.

In *John Wyeth v Cigna*[94] a primary insurer exercised its right under a buy-out clause, capping its liability by making payment of the maximum amount for which it might be liable under the (product liability) policy. Not until four years later was it ascertained how many claims there were and into which years they fell. The underlying product liability litigation ultimately failed but significant defence costs were incurred. The Court of Appeal held that the primary layer had been exhausted and the excess layer triggered by the exercise of the buy-out clause: in those circumstances payment by the primary of actual claims was not necessary for the excess layer to become liable for the defence costs incurred after the buy-out in relation to claims which fell within the terms and conditions of the excess. There was to be no apportionment to reflect periods when they were not on risk. There was a "maintenance clause" in the excess layer policies under which the insured warranted that the primary cover would be maintained in force, except for reduction in aggregate limits "caused solely by payment of claims". It was held that this had not

been breached by the exhaustion of the primary layer by the exercise of the buy-out rather than payment of actual claimants.

Recovery is usually applied top-down so that insurers at the top benefit first. The usual justification for this it that primary insurers usually receive more premium. Clauses in excess contracts normally provide that recovery shall be applied "as if recovered or received prior to such settlement".

Endnotes

1 This article is based on a BILA lunchtime talk given on 20 January 2012 by the authors, Julian Burling, a barrister practising at Serle Court chambers ("Leaders and Followers"), Helen Ashenden, Senior Claims Manager, Lloyd's Market Performance ("Lloyd's Claims Scheme"), and Jacquetta Castle, Fishburns LLP ("Excess Layers").

2 http://www.marketreform.co.uk/Documents/RD_Doc_Archive/GUA211206.pdf.

3 3rd ed,, London, Sweet and Maxwell, 2010, para 3-059, n 182.

4 [2002] Lloyd's Rep IR 374.

5 At 377-8.

6 At 380, [6].

7 [1987] 1 Lloyd's Rep 471.

8 Ibid, at 475.

9 [1994] 2 Lloyd's Rep 99.

10 ibid, at 106.

11 [1998] 1 Lloyd's Rep 423.

12 [2011] EWHC 2413 (Comm), [2012] Lloyd's Rep IR 52.

13 Eg The Buana Dua: "follow AXA".

14 *Unum* v *Israel Phoenix* [2002] 1 Lloyd's Rep IR 374, at 377 (Andrew Smith J).

15 *Roadworks (1995) Ltd* v *Charma*n, at 105. See also *Youell v Bland Welch* [1990] 2 Lloyd's Rep 423, at 429, per Phillips J, *obiter*.

16 [1998] Lloyd's Rep IR 93, at 143-144.

17 [1994] 2 Lloyd's Rep 99, at 106.

18 [2005] EWCA Civ 1512.

19 [2005] EWCA Civ 1512, [2006] 2 Lloyd's Rep 152.

20 *The Leegas* [1987] 1 Lloyd's Rep 471, at 475.

21 [1998] 1 Lloyd's Rep 423 ,at 430, *obiter.*

22 *Unum Life, at 378.*

[23] Ibid. cf the view expressed in Colinvaux 1-040.

[24] .[1984] 1 Lloyd's Rep 58, at 85-86.

[25] .ibid, at 597.

[26] [1985] 2 Lloyd's Rep 529, 538.

[27] [1995] 2 AC 145.

[28] [2006] EWHC 424 (Comm), [2006] 1 Lloyd's Rep 549.

[29] [2006] EWHC485 (Comm), [2006] Lloyd's Rep IR 493; affirmed [2007] EWCA (Civ) 710, [2007] 2 Lloyd's Rep 278.

[30] The Zephyr[1985] 2 Lloyd's Rep 529, at 539.

[31] [1998] 1 Lloyd's Rep 565.

[32] Ibid, at 596, col 1.

[33] ibid, at 597.

[34] [2000] Lloyd's Rep IR 12 (CA).

[35] *International Lottery Management* v *Dumas* [2002] Lloyd's Rep IR 237, 258 at [78]; *International Management Group* v *Simmonds* [2003] EWHC 177 (Comm), [2004] Lloyd's Rep IR 247, at [150]-[152]; *Brotherton* v *Aseguradora Colseguros (No.3)* [2003] EWHC 1741(Comm), [2003] Lloyd's Rep IR 762, 779 at [44]. For reservations about the trend of this line of authorities see Merkin, *Colinvaux's Law of Insurance*, 9th ed, London, Sweet and Maxwell, 2010, p307.

[36] eg. *Brotherton*, at [44].

[37] [1999] Lloyd's Rep IR 343.

[38] *Insurance Company v Lloyd's Syndicate* [1995] Lloyd's Rep IR 37, at 39, col 2.

[39] Ibid, at 40, col 2.

[40] [1998] 1 Lloyd's Rep 423, at 430 per Mance J.

[41] [2011] EWHC 2413 (Comm), [2012] Lloyd's Rep IR 52.

[42] *Roar Marine,* at 430.

[43] Ibid, at 427.

[44] *Buana Dua*, at [17]-[29], emphasis added.

[45] *Roar Marine*, at 427, col 1, 430, col 1.

[46] *Buana Dua, at [26].*

[47] *Roar Marine*, at 430.

[48] Underwriting Requirements, para 3A, except where the slip relates to motor, personal lines or term life business and is not to be processed by LPSO.

[49] GUA, clause 3.

[50] Ibid, clause 4.

[51] It is not quite clear whether this is to be construed, literally, as meaning that the agreement of all is necessary for any of them to be bound, or, as seems more likely from the context and the reference to the Underwriter's own proportion, that none is to be bound as regards its own several contract unless it has agreed the slip provision or amendment .

[52] GUA, clause 10.

[53] GUA clause 6.1, 6.2.

[54] Ibid, clause 7.

[55] Ibid, clause 8.1.

[56] Ibid, clause 8.2.

[57] Ibid, clause 9. The former market agreements expressly provided that they did not form part of any contract with the assured.

[58] Lloyd's Market Bulletin Y4522, 30 September 2011, *Lloyd's Claims Scheme (Combined) and Expansion of Scope of 2010 claims Scheme under Claims Transformation Programme.*

[59] 2010 Claims Scheme, para 2(d), sch 5. Dispute resolution proceedings are litigation, arbitration, regulatory or other contested proceedings.

[60] Ibid, para 2(d).

[61] Ibid, para 2(d).

[62] Ibid, para 3.

[63] See Market bulletin Y4531, 10 November 2011, *Claims Transformation Programme: Revised 2010 Claims Scheme Process Guidelines.*

[64] 2010 Claims Scheme, para 4.

[65] Ibid, para 5.

[66] Ibid, para 7.

[67] Ibid, para 10.

[68] Ibid, paras 5 and 7.

[69] Ibid, paras 27-31.

[70] Ibid, para 2(e).

[71] Ibid, para 2(f).

[72] Ibid, para 9.

[73] Ibid, para 17.

[74] Ibid, paras 14, 15.

[75] Ibid, paras 18, 19.

[76] Ibid, paras 20-22.

[77] Market bulletin Y4531, above.

[78] [2011] EWCA Civ 1572.

[79] [2004] EWHC 1799 (Comm), [2005] Lloyd's Rep IR 135.

[80] [2005] EWCA Civ 601, at [14], [2006] Lloyd's Rep IR 45.

[81] [2009] EWHC 2900 (Comm), [2010] Lloyd's Rep IR 149, at [203], Hamblen J.

[82] [2004] EWHC1799 (Comm), at [14].

[83] Ibid, at [17].

[84] Ibid, at [19].

[85] Ibid, at [29].

[86] [2009] EWHC 2900 (Comm), [2010] Lloyd's Rep IR 149.

[87] See helpful summary by Linda S Woolf,Goodall DeVries Leech & Dann FDCC Journal July 2005.

[88] 843 So.2d140 (Ala.2002).

[89] [1989] 1 Lloyd's Rep 265.

[90] [2009] EWHC 1115 (Comm), [2010] Lloyd's Rep IR 132.

[91] [2011] EWCA Civ 1572.

[92] See, for example, *Hudson Ins Co v. Gelman Sciences Inc* 706 F Supp 25.

[93] [2005] EWCA Civ 928, [2006] Lloyd's Rep IR 31.

[94] [2001] EWCA Civ 175, [2001] Lloyd's Rep IR 420.