Claims Co-operation Clauses in Facultative Reinsurance Contracts: Reinsurers Back in the Driving Seat

By Michael Graham and Rachael Williams

The construction and effect of claims co-operation clauses in facultative reinsurance contracts was reconsidered once more in the case of *Gan –v- Tai Ping* [2001] Lloyd's Rep IR 667. In this article, we look at the purpose of claims co-operation clauses alongside this recent decision, which upholds the validity of the widely used claims co-operation clauses on Scor forms.

Claims co-operation Clauses:

A Claims co-operation clause will at the minimum usually provide that the reinsured agrees to consult and co-operate with reinsurers on claims handling and settlement.

Alternatively, reinsurance wordings may contain a more elaborate 'claims control clause requiring the reinsured to: (1) notify reinsurers of a claim or circumstances likely to give rise to a claim, immediately or within a stated time or as soon as reasonably practical; and (2) allow the reinsurer to appoint assessors, surveyors, or loss adjusters, and to control all settlement negotiations relating to the underlying loss.

Obligations under such clauses are usually well defined by the wordings used and the standard wordings will often state explicitly that the reinsured's compliance with certain obligations is a condition precedent to the reinsurers' liability under the contract.

The construction of a standard claims co-operation clause was examined by the Court of Appeal in *Gan –v- Tai Ping.*

Facts

The dispute was between Tai Ping Insurance Company Limited ("Tai Ping") a Taiwanese insurer, and their reinsurers, Gan Insurance Company Limited ("Gan"). The claim arose under an erection all risks ("EAR") insurance relating to machinery for the production of computer chips. The machinery was to be installed in a building in a science park in Taiwan.

The original insured was Winbond Electronics Corporation ("Winbond"), the manufacturer of the chips and the owner of both the machinery and the building. Winbond sought cover against all risks of loss and damage to the relevant

machinery while it was in the process of erection, installation and commissioning. After hand over, the machinery would be insured under an ordinary fire policy. Tai Ping, as leader, took a 35% line on the original EAR insurance and also took a lesser line on the fire insurance. Central Insurance Company Limited ("Central") took a 15% line on the original insurance following Tai Ping. Both Tai Ping and Central sought reinsurance of their original lines. Tai Ping were able to place almost 96% of their 35% line without recourse to London placing brokers. The remaining 2% of Tai Ping's exposure was placed with Gan and 2% with Eagle Star through a London broker. Central reinsured their 15% line with Royal Insurance as leader. Gan as following reinsurer, took a reinsurance line of 2.5% of Central's share.

On 14 October 1996, there was a fire in the building causing substantial damage to the machinery.

The Claims Co-operation Clause

The reinsurance wording contained a claims co-operation clause in the following terms:

> "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 any 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 the 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 the reinsurers."

This form of wording has been widely used following the decision of the Court of Appeal in *Insurance Company of Africa –v- Scor (UK) Reinsurance Co Ltd* (1985) 1 LLR 312. Scor failed to persuade the trial judge that the underlying claim of the original insured against ICA was invalid. They then relied upon a claims co-operation clause in the reinsurance agreement which stated inter alia:

"It is a condition precedent to liability under this reinsurance 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".

However, the Court of Appeal in Scor held the above clause to be disjunctive and only the first part of the clause relating to the obligation to notify claims promptly was held to be a condition precedent.

Following the Scor decision, the form of words used in *Gan –v- Tai Ping* was adopted by many reinsurers.

The Issues before the Commercial Court

The four preliminary issues of construction before Longmore J at first instance in the Commercial Court ([2001] Lloyd's Rep IR 291), were as follows:

1 Was compliance by Tai Ping with the provisions of the claims co-operation clause a condition precedent to liability on the part of Gan?

2 Whether breach of sub-paragraph (c) of the claims co-operation clause was only established by showing that Tai Ping both settled and/or compromised Winbonds' claim *and* admitted liability;

3 Whether there were to be implied into the slip policy terms that:

(a) Reinsurers could not withhold approval of a settlement unless there were reasonable grounds for withholding approval;

(b) Reinsurers would respond with reasonable promptness to a request for approval of a settlement;

4 Whether Tai Ping was entitled, even if shown to have been in breach of the claims co-operation clause, to recover under the policy, if it could show it was liable in fact and in law to Winbond for at least its proportion of the settlement figure.

Longmore J determined these issues as follows:

1 Yes.

2 Yes.

3(a) Yes.

3(b) Longmore J did not think it useful to answer this issue, "because, if a request goes unanswered, it will be tantamount to a refusal".

4 No.

Tai Ping then applied for a summary determination of certain issues. Andrew Smith J held (8 February 2001) (unreported) that:

(a) Tai Ping had not failed to co-operate;

(b) By settling on the basis that an insured peril had occurred and an agreed sum was due under the direct policy, the reinsured had not admitted liability to the assured, as there was no reference in the settlement statements to possible defences.

The Issues before the Court of Appeal

Gan appealed Longmore J's decision on points 2 and 3(a) above. Tai Ping, contingent upon Gan pursuing its appeal, appealed Longmore J's decisions on issues 1 and 4. Gan also appealed Andrew Smith J's decision at point (b) above, which depended on the correct answer to issue 3(a), also under appeal.

The Decision of the Court of Appeal

Issue 1: Was compliance by Tai Ping with the claims co-operation clause a condition precedent on the part of Gan?

Mance LJ, delivering the leading judgment of the Court of Appeal, agreed with the Commercial Court's decision that the clause expressly stated that compliance with each of the terms of the clause was a condition precedent to Gan's liability.

Issue 2: Whether Breach of Sub-Paragraph (c) of the claims co-operation clause was only established by showing that Tai Ping both settled and/or compromised Winbonds' claim and admitted liability

The Commercial Court found in favour of Tai Ping by holding that a breach of the condition precedent at sub-paragraph (c) of the claims co-operation clause could only be said to have occurred in circumstances where the reinsured both compromised a claim *and* admitted liability. The inclusion of the words "*and* liability admitted" meant, accordingly, that a settlement concluded by the reinsured without an admission of liability was not a breach of the claims co-operation clause.

The Court of Appeal reversed the judges decision: it held that the clause had no obvious meaning. The Court of Appeal held that Longmore J's interpretation made no commercial sense. It was highly improbable that the parties intended this "double hurdle" and that the better interpretation was that there was a breach of sub-paragraph (c) of the claims co-operation clause if the reinsured either settled *or* admitted liability without the prior approval of the reinsurers.

Issue 3: Whether there were to be implied into the slip policy terms that reinsurers could not withhold approval of a settlement unless there were reasonable grounds for withholding approval

The Commercial Court held that there was to be implied into the clause on business efficacy grounds, an obligation on the reinsurer not to withhold unreasonably its consent to a settlement reached by the reinsured. Without such an implied term, Longmore J reasoned that a reinsurer may never have to indemnify its reinsured unless they decided to do so.

The Court of Appeal rejected this reasoning. The Court of Appeal did hold, however, that the right of reinsurers to withhold approval of a settlement was not unqualified. Reinsurers must act in good faith after considering the facts giving rise to the particular claim and not act arbitrarily. Furthermore, reinsurers could not withhold their consent to a settlement on the basis of extraneous considerations.

Mance LJ gave examples of when a reinsurer's refusal to approve a settlement could be based on extraneous reasons. He said that a refusal unconnected to the merits of the claim in an attempt to influence an insurer's attitude in relation to a matter arising under a separate reinsurance or to harm an insurer as a competitor in respect of other business or in the eyes of a local regulator would be examples of extraneous reasons.

The Court of Appeal also made it clear that reinsurers and insurers should, in performing their respective roles under sub-paragraph (b) and (c) of the claims co-operation clause consider the original claim objectively and as a whole without regard to their own sectional exposure as insurer or reinsurer. Just as it would be wrong for insurers to settle a claim without real regard to its merits because the burden would fall on their reinsurers, so it would be wrong for reinsurers to insist on a claim being fought regardless of its real merits, for example, because the reinsurance cover was very limited and they hoped a complete defence might

emerge. Reinsurers, however, do not have to establish positively that there were reasonable prospects of defeating a claim as a pre-condition of refusing consent.

Mance LJ elaborated that it was the insurers, and not reinsurers, who receive, investigate and have the handling of any claim, although sub-clause (b) requires them to co-operate with reinsurers. The right to withhold approval under sub-clause (c) must allow a reinsurer to take the view that a particular claim is one that should be strictly proved by the original insured, or to take a view as to an appropriate level of settlement prior to its being so proved.

The court said it had reached its conclusions because the parties could not be subjected to a reasonableness requirement as this would involve the court substituting its own views for that of the reinsurer.

Mance LJ observed that the possibility that disagreement may arise as to the merits of a proposed settlement is inherent in sub-paragraph (c). He explained that if an insurer placed a 100% reinsurance, with a claims co-operation clause in the present form, he accepted the risk that its reinsurer may, when evaluating a claim, reach a different conclusion to its own with regard to settlement. If the insurer only placed a 50% reinsurance, with such a clause, he accepted the risk that its reinsurer may insist on its own view of the merits for a proposed settlement. Similarly, if the insurer placed 10 reinsurances, each for 10%, and failed to insist on a leading underwriter clause, whereby all reinsurers must follow a leader, it risks, at least in theory, being presented with up to 10 different views as to what would constitute a reasonable settlement.

Whilst recognising these difficulties, the court held that the right to withhold approval was, in this case, Gan's and no one else's. This difficulty is being addressed, at least in the London market, by the London Market Principles 2001/2 reform process which has proposed "lead underwriter only" clauses. If implemented, these clauses will ensure claims settlement is decided for all participating reinsurers by the lead reinsurer.

Issue 4: Whether Tai Ping was entitled, even if shown to have been in breach of the claims co-operation clause, to recover under the policy, if it could show it was liable in fact and in law to Winbond for at least its proportion of the settlement figure

Mance LJ stated that this question raised an issue as to whether the claims co-operation clause, or at any event sub-paragraph (c), is intended to be a condition precedent to liability of any sort under the policy, or precedent only to liability that

would otherwise arise under the "follow the settlements" provision in the Full Reinsurance Clause. The Court of Appeal agreed with Longmore J's judgment that non-compliance with the claims co-operation clause was a condition precedent to the liability of the reinsurer and non-compliance meant that the reinsured could not recover, even if it could prove that it was liable to indemnify the insured in fact and in law. This part of the judgment has particularly draconian consequences for cedants who are in breach of their obligations under similarly worded claims co-operation clauses.

Conclusion

The decision is, generally speaking, bad news for cedants and good news for reinsurers. Great care needs to be taken by cedants in complying with their obligations under the Scor claims co-operation clauses and other similarly worded clauses. This decision has shown that the expectation that many cedants have that reinsurers will invariably follow the settlements which have been concluded with local insureds is misplaced if the reinsurance contains a Scor claims co-operation clause. The lesson of the Court of Appeal's judgment is that cedants must ensure that they have an early and on-going dialogue with their reinsurers about handling claims and they should not conclude a compromise settlement with their insureds without obtaining the prior approval of their reinsurers. If this approval is not given the safest course of action is not to agree a compromise settlement and wait to be sued. This may be commercially unattractive but unless this course of action is taken cedants may well have to bear any settlement for their net account. Alternatively, in view of the difficulties caused by the Scor clause, cedants and their brokers should consider trying to negotiate a less draconian claims co-operation clause than the Scor clause at the time of the placement of the reinsurance. However, in the post 11 September market, cedants may well find it difficult to persuade their reinsurers to agree to a less onerous claims co-operation clause.

Michael Graham is a partner and Rachael Williams an assistant solicitor in the Reinsurance & International Risk team,

Barlow Lyde & Gilbert.

A shorter version of this Article was published in Asia Insurance Review in September 2001.