Murphy -v- Brentwood. It is interesting that what the House of Lords thought perfectly proper to take away with one hand it now considers it ought to give back with the other.

5. The Court of Appeal, when considering *Linden Gardens,* in their own way round the failure to properly assign the benefit of the building Contract, held that the loss suffered by Corporation in having to compensate Investments (in respect of their breach of warranty of authority in failing to obtain consent to the assignment) was the same as the cost of the remedial works. The House of Lords however considered this to be irrecoverable from McAlpine on the basis that it was not properly forseeable by McAlpine in view of the prohibition on assignment. How Investments loss can be any more recoverable from McAlpine simply because it is claimed through the conduct of Corporation is difficult to see. The point may conceivably be arguable in the case of two inter-related companies but would it be in the case of a completely unrelated third party purchaser?

Nor, is justice to the community at large ever being done if a 1993 House of Lords decides a case on the basis of an 1839 House of Lords' decision which has never been properly relied on in the 160 years since it was handed down and which was almost certainly never authority in the first place for the proposition now advanced.

REINSURANCE DISPUTE RESOLUTION - RECENT TRENDS AND RECENT CASES by Michael Mendelowitz, Barlow Lyde & Gilbert.

Introduction

I hope you will not mind if I take advantage of my position as a speaker stepping in to fill a breach at relatively short notice, to redefine slightly the substance of my presentation this afternoon. "Reinsurance litigation" is, it seems to me, rather too narrow a topic – particularly if one construes "litigation" strictly as what goes on in the Queen's Bench Division, Commercial Court. The fact is – as I am sure all of you are aware – that the vast majority of reinsurance cases proceed by way of arbitration rather than in court. It also happens to be the case that some of the most interesting judgments to have emerged from the Commercial Court over the last few months are, directly or indirectly, concerned with the way in which reinsurance disputes are handled. I have, therefore, entitled this talk "Reinsurance Dispute Resolution – Recent Trends and Recent Cases."

Methods of Dispute Resolution

1. **ADR**

One striking development – which although perhaps not that recent in origin seems to be gathering momentum all the time – is an interest in forms of alternative dispute resolution, or "ADR". (I would add, parenthetically, that although a lot of people are currently taking about ADR, very few of them – in the reinsurance field at any rate – are actually practising it. This may be for very good reasons, upon which I shall elaborate slightly later.)

When the concept of ADR is explained to those engaged in the reinsurance markets (including their legal advisers), their reaction is much the same as that of Monsieur Jourdain, the *bourgeois gentilhomme* of the play of the same name by Moliere. Monsieur Jourdain it was, you will recall, who found out one day, to his immense surprise and delight, that he had been speaking prose all his life without realising it. Almost all of us have, at one time or another, been involved in ADR, although we may not have realised that that was what we were doing. A great part of litigation solicitor's practice – especially one dealing predominantly with reinsurance disputes — consists of alternative dispute resolution: that is, in essence, having the parties resolve their disputes for themselves, rather than having those disputes resolved for them by a judge or other independent adjudicator.

What most people have in mind, however, when they speak of ADR, is a more formal process than the horse-trading which goes on – sometimes quite literally – up to the doors of the court. This type of ADR suggests itself, and is most likely to succeed, where the parties stand to gain by the maintenance of a continuing commercial relationship with one another, whereas arbitration and litigation are more apposite where relationships between the parties have already been severed or are likely to be severed in the near future.

Subject to its limitations, with which I shall deal later, there is probably no real disadvantage to ADR other than the fear of a "carve up" rather than a decision made in accordance with the rights of the parties. A party to ADR, who has a good case, may feel thwarted by a decision which does not follow the merits but merely "divides the baby", as King Solomon once suggested should be done. (Cutting the baby in half was, of course, the last thing which King Solomon actually intended, but sometimes I wonder whether ADR neutrals realise that. The same criticism, I am sorry to say, can sometime be levelled against arbitrators, particularly in the USA.) Even if the parties have agreed that the outcome of their ADR shall not be binding, suggestions made by conciliators, mediators or adjudicators inevitably create certain expectations in the parties' minds.

On the other hand, ADR probably has no positive independent advantages: its success can only be measured in terms of the results which it achieves. If ADR works, it can work spectacularly in as much as the parties both agree upon a solution which satisfies them; if it fails, the parties go back to square one but they are not likely to be worse off in any material respect. They will have lost some time, but this may be compensated for because if their dispute proceeds to litigation or arbitration, the time expended in the ADR process should have clarified the issues and so give the next stage of the dispute resolution process a head start.

What does all of this suggest about the role of ADR in reinsurance disputes? For one thing, where a binding precedent is required – for example because the resolution of a number of similar disputes will depend upon the way in which a test case is decided – ADR would clearly be inappropriate. Another category of cases in which ADR is not likely to be useful is where dishonesty or bad faith is present, either in the facts which give rise to the dispute, or in the conduct of the dispute itself. Most complex reinsurance disputes are, therefore, probably not capable of being resolved by ADR. Often the market will require firm guidance for the handling of similar problems in the future; and in many reinsurance cases, the issue is whether the reinsurer is entitled to avoid the contract ab initio by reason of non-disclosure or misrepresentation on the part of the reinsured.

ADR is also less likely to work well (although it cannot be ruled out altogether) in a situation where future commercial relations between the parties are not important. Given that one or other of the parties to reinsurance disputes these days is more likely than not to have ceased underwriting activities and to be in run-off, the prospects for ADR in the reinsurance market are further diminished.

2. Equitable Arbitration

Another development (which may not be entirely unrelated) is the growing support about which one hears for the concept of equitable arbitration – that is, giving arbitrators the power to make decisions without being fettered by legal rules or any of the other restrictions which the Court of Appeal in *Home* -v-*Mentor* suggested might apply to them, even when acting pursuant to an "honourable engagement" clause. I understand that a new Arbitration Act is under consideration by the Department of Trade and Industry's Departmental Advisory Committee on Arbitration Law. That committee is chaired by Lord Justice Steyn, the President of BILA. The Departmental Advisory Committee intends, I believe, to publish a consultation paper in the summer. One of the proposals which will appear in it – but only if, as I understand the situation, there is support for such a proposal from the commercial community who would be affected by it – is that the Arbitration Act be amended by the incorporation of a provision from the UNCITRAL Model Arbitration Law to the effect that, if the parties to an arbitration agree, the tribunal may decide the matter *ex aequo et bono* or as *amiable compositeur*. I believe that the move to amend the Arbitration Act in this way deserves the support of the reinsurance community and of BILA (who I know are considering the proposal), even if equitable arbitrations are going to be of more use to commodity traders than to reinsurers and reinsureds. (The concern behind the proposed amendment appears to me to be that London might lose its pre-eminence as a commercial arbitration centre if parties are able to go elsewhere and have their disputes resolved in an equitable manner, but cannot do so in London. Given that the arbitration clauses in practically every London market reinsurance contract specify that the proceedings shall be held in London, this is a matter, I should have thought, of rather less importance to the reinsurance market than to other commercial men and women.) Nevertheless, there is no reason why the parties to a reinsurance dispute should be deprived of the opportunity to have that dispute determined according to the arbitrators' notions of justice and fairness, if that is what the parties indeed desire.

Having said that, I should add straight away that I would advise any client of mine, in the strongest terms, not to agree to an equitable arbitration. The example which is often put forward in support of the desirability of such arbitrations is that of the non-disclosure which would not have caused the prudent underwriter to decline the risk, but would have led him to re-rate the premium. In such cases, should the reinsurer be allowed to avoid the policy altogether? Is not the just result that the claim should be paid, less an allowance for the increased premium which the reinsurer would have demanded had proper disclosure been made? There is undoubtedly force in this particular argument when applied to genuinely inadvertent non-disclosure (and I shall discuss in a moment or two a very recent case in which this precise point arose). I would maintain, however, that the disadvantages outweigh the advantages. For one thing, the law (if anything which could be described as "the law" remained) would be uncertain, and advice to reinsureds and reinsurers concerning their rights and liabilities in cases of misrepresentation and non-disclosure would become extremely difficult, if not altogether impossible. For another, we have seen, in the underwriting results of the late 1970's and early 1980's, what happens when brokers of less than top drawer quality are tempted to present bad risks to underwriters who are known to fly by the seats of their pants, particularly after lunch on Fridays. I suggest that the London market does not really want to return to the days when this sort of practice was all too common. Is a reinsurer in such circumstances to be denied the right to avoid for non-disclosure, simply on the grounds that the underwriter in question would have accepted the risk even if proper disclosure had been made? Rigid and objective standards may appear to operate harshly in hard cases, but they do serve to keep the ethical and professional standards of the London market at a high level.

Recent Cases

Against that background, let me turn to a discussion of two recent cases.

1. Harbour v. Kansa – Arbitrators and Illegality

The first case I should like to discuss briefly is *Harbour Assurance Co. (UK) Ltd. -v- Kansa General International Insurance Co. Ltd. & Ors.*, a judgment of the Court of Appeal handed down on 28th January this year. The facts of the case are probably familiar to you from the judgment of Steyn J (as he was then) at first instance, reported at the beginning of last year. Harbour issued a writ claiming a declaration that certain retrocession contracts in terms of which Harbour reinsured Kansa and others were void and that Harbour was not liable for any losses presented thereunder. The allegation of voidness was based on the fact that Kansa and the other defendants were not registered or approved to effect or carry on insurance or reinsurance business in this country by the DTI under the Insurance Companies Acts 1982 or any of its predecessors. As pointed out by both Hoffman and Ralph Gibson LJJ, there was a possible flaw in the plaintiff's argument: the fact that contracts written by Kansa may have been illegal and unenforceable (which Kansa in any event denied) did not necessarily of itself render the retrocessions to Harbour void. There was therefore the real possibility that the questions before the court were in fact moot. The Court of Appeal nevertheless agreed to decide them.

Those questions related to the fact that the retrocession agreements all contained arbitration clauses. Faced with Harbour's writ, Kansa and the other defendants issued a summons for a stay of the proceedings pursuant to the Arbitration Acts. Thereafter, the question of the nullity of the retrocession agreements was ordered to be tried as a preliminary issue, and in the course of that trial a "pre-preliminary" issue arose: should the court in fact decide the preliminary issue at all, or should it be decided by arbitrators? Steyn J held, with evident reluctance, that arbitrators could not decide questions of initial invalidity of the contract pursuant to which they were appointed. He therefore dismissed Kansa's application for a stay. The Court of Appeal reversed Steyn J's decision, but only on the question of the effect of previous authority, which Steyn J had decided was binding on him, but which the Court of Appeal held to be distinguishable. Both Steyn J and the Court of Appeal agreed that there exists in English law a principle of the separability of the arbitration clause or agreement from the contract in which it is contained and, provided that the arbitration clause itself is not directly impeached, the arbitration agreement is capable of surviving the invalidity of the substantive contract within which it is contained, so that the arbitrators can have jurisdiction under the clause to determine the initial validity of that contract. The Court of Appeal ruled that there was no difference in principle between questions of initial invalidity and any other matter alleged to affect the enforceability of the substantive contract. Accordingly, Kansa's application for a stay of the proceedings was granted.

An arbitration tribunal will, accordingly, now be given the opportunity to determine whether the way in which Kansa and the other defendants conducted their business was indeed illegal and, if so, what the effects of that illegality should be. Depending upon just how confidential the proceedings remain, we may never know what the arbitrators decide in this regard. Presumably, if the arbitrators come to the conclusion on the facts that the defendants were in contravention of the Insurance Companies Act 1982, they cannot be liable under any inwards business assumed by them and consequently would have no insurable interest in those risks which they could retrocode to Harbour. In this regard, the arbitrators would probably follow *Phoenix General Insurance Co. of Greece SA* -v- *Administratia Asigurarilor de Stat* [1986] 2 Lloyd's Rep. 552 and the more recent case of *DR Insurance Co.* -v- *Seguros America Banamex* [1993] 1 Lloyd's Rep. 120. A fascinating possibility might be presented, however, if the arbitrators in this matter were at liberty to decide these questions on the basis of equity rather than law. (Fortunately or unfortunately, depending upon one's particular point of view, the arbitrators will – as far as I can tell – have to decide the issues according to English law.) Would an equity clause allow arbitrators to override the effect of an Act of Parliament? Alternatively, could the arbitrators, while purporting to apply the Insurance Companies Act, come up with an interpretation of that Act fundamentally opposed to the interpretation put upon it by the Court of Appeal in *Phoenix* -v- *ADAS?* Could the arbitrators declare, contrary to the judgment of Adrian Hamilton QC in *DR* -v- *Seguros America,* that Section 132 of the Financial Services Act 1986 is retrospective and therefore overrules *Phoenix* -v- *ADAS?* We shall almost certainly never know the answers to these questions. Indeed, the questions themselves may never arise. *Harbour* -v- *Kansa* does, however, throw a spotlight on the potential consequences of allowing arbitrators to decide the issues presented to them in any way other than according to established rules of law.

2. **Pan Atlantic v. Pine Top – Materiality**

Finally this afternoon, I should like to discuss a case which is very recent indeed: judgement was in fact only handed down last week. The Court of Appeal has delivered its long-awaited judgments in *Pan Atlantic Insurance Co. Ltd* -v- *Pine Top Insurance Co. Ltd.* on the test of materiality where misrepresentation and non-disclosure are concerned. The facts of the case are too complex to go into in any detail today. Suffice it to say that between 22nd or 23rd December 1981 (when the reinsured's broker presented a 1982 reinsurance slip to the reinsurer's underwriter) and 13th January 1982 (when the underwriter signed the slip) the reinsured obtained information about additional losses which materially worsened the 1981 loss record, and these additional losses were not disclosed to the reinsurer. The trial judge held (and the Court of Appeal did not disturb his finding) that both a hypothetical prudent underwriter and the actual underwriter in the case might have been influenced, had the additional losses been disclosed, as to the terms upon which he was willing to subscribe to the reinsurance. Of course, if the judge had simply applied the test laid down by the Court of Appeal in *Container Transport International* -v- *Oceanus Mutual Underwriting Association Ltd.* [1984] 1 Lloyd's Rep. 476, the question of how the actual underwriter might have reacted would have been immaterial for two reasons. First, the test is strictly objective and depends not upon what the actual underwriter may have thought, but rather upon a notional or hypothetical figure, the "prudent insurer" of Section 18 (2) of the Marine Insurance Act 1906. Secondly, it is not necessary for an insurer to establish that, but for the non-disclosure, a prudent insurer would not have written the risk at all or, if he did so, he would have done so on different terms: all that has to demonstrated is that the prudent insurer would wish to have been made aware of the fact which was not disclosed in reaching his decision. It is possible, therefore, that the non-disclosure would have had no actual effect on a prudent insurer's underwriting judgment, but nevertheless the contract may be avoided. Pan Atlantic nevertheless persuaded Waller J at first instance to make findings of fact in relation to the actual underwriter in the case so as to pave the way for a challenge in the House of Lords to the law as laid down in *CTI* -v- *Oceanus*.

The Court of Appeal was asked to review Waller J's findings of fact, but declined to do so on the grounds that it was impractical to embark on a hypothetical fact finding exercise based upon a supposition that the law was not in fact what the Court of Appeal had stated it to be in *CTI* -v-*Oceanus*. The Court of Appeal evidently felt that it was able, in any event, to decide the appeal on a different basis.

Steyn LJ, in the leading judgment, recognised that *CTI* -v- *Oceanus* has been a "remarkably unpopular decision, not only in the legal profession but also in the insurance markets." The thrust of the criticism is that the decision is a charter for poor underwriting, since it makes it possible for insurers to avoid contracts on the flimsiest of grounds. I happen to be among those who believe the decision is supportable on the policy grounds which I mentioned earlier (namely that it keeps reinsureds and their brokers on their toes and forces them to focus their attention on making a fair presentation of the risk to their reinsurers), but I have to confess to some uneasiness as to whether the intention of the drafters of the Marine Insurance Act was quite what the Court of Appeal in *CTI* -v- *Oceanus* held it to be.

Be that as it may, a differently constituted Court of Appeal in *Pan Atlantic* -v- *Pine Top* has refined the test of materiality in a way that takes the sting out of at least some of the criticism of *CTI* -v- *Oceanus*. The Court of Appeal has now held that, in order to be material, a non-disclosure (and presumably a misrepresentation as well) must have rendered the risk a different and increased risk from that assumed in the absence of disclosure (or if the representation was true). Steyn LJ summed up his judgment as follows:

> "I would rule that, as the law now stands, the question is whether the prudent insurer would view the undisclosed material as probably tending to increase the risk. That does not mean that it is necessary to prove that the underwriter would have taken a different decision about the acceptance of the risk. After all, there may be many commercial reasons for still writing the risk on the same terms. But if the concept of 'influence' is interpreted in accordance with

[this] solution, it seems to me that it is easier to fit the *CTI* -v- *Oceanus* decision within the framework of our insurance law and its results in a somewhat fairer and more balanced principle of materiality as between insured and insurer and the difficulties which this decision has caused in practice will be considerably ameliorated."

In other words, the insured (or reinsured) does not have to disclose absolutely every fact to the insurer (or reinsurer) in case the reasoning processes of a prudent insurer might have been influenced by those facts: the only facts which it is necessary to disclose are those which increase the risk.

One final comment on *Pan Atlantic* -v- *Pine Top*. Farquharson LJ was content simply to concur in the judgment of Steyn LJ. The Vice-Chancellor, however, who was the third member of the Court of Appeal, delivered a separate judgment, in the course of which he made the following observation:

> ". . . the result of setting aside this reinsurance treaty is that the reinsurer avoids all liability for his own bad bargain and, moreover, does so even though full disclosure would have resulted, not in his declining to take the risk, but only in an increased premium. Justice and fairness would suggest that when the inadvertent non-disclosure came to light what was required was an adjustment in the premium or, perhaps, in the amount of the cover. Those are not options available under English law. The remedy is all or nothing. The contract of insurance is avoided altogether, or it stands in its entirety. This is not the only field in which English law still seems to adopt a fairly crude, all or nothing approach, when what is needed is a more sophisticated remedy more appropriate, and in that sense more proportionate, to the wrong suffered. The introduction of a judicial discretion into this field would not be without its advantages. These were considered by the Law Commission in 1980 in its report on non-disclosure and breach of warranty in insurance law . . . but the present case is an unhappy example of a case where, in the absence of discretion, the law manifestly does not produce a satisfactory result."

No doubt these remarks will be taken up and given much publicity, and there will be calls for the introduction of proportional remedies, or a judicial discretion, or some other means of making insurance law "more fair". Do I detect echoes of the same arguments as are being advanced in favour of equity arbitration clauses?

There are, I suggest, three good reasons why the Vice-chancellor's comments in

Pan Atlantic -v- *Pine Top* should go unheeded. First, a decision about what a prudent (or any) insurer would have done had a material fact been disclosed, or a material misrepresentation not been made, must inevitably be made with the benefit of hindsight. In the real world, insurers and reinsurers do not seek to avoid insurance or reinsurance contracts simply because there was non-disclosure or misrepresentation; they do so because they are being asked to pay disastrous losses. It must be extraordinarily difficult to try to ignore such losses when deciding whether a prudent insurer would have declined the risk altogether, or accept only lower limits, or imposed a higher deductible, or re-rated the premium – which are the sorts of decisions which would have to be made in order for a "proportional" remedy to be applied. Secondly, the very foundation of the insurance contract, utmost good faith or *uberrima fides,* seems to have flown out of the window. We should not lose sight of this principle, since it rests on a very sound footing, namely that the insured knows all the relevant facts, and the insurer knows none. Avoidance of the contract is the insurer's (or reinsurer's) only realistic means of protecting his interests. If the reinsured's non-disclosure or misrepresentation is inadvertent, that is unfortunate, but why should the reinsurer suffer as a result? In any event, there will the prospect of compensation for the reinsured in many cases because the presentation of the risk will have been made on his behalf by a broker, and if the broker did not take sufficient care to marshall the relevant facts for purposes of the presentation, he may be liable in damages to the disappointed reinsured.

Thirdly and finally, the Vice-Chancellor appears to have lost sight of the distinction between consumer insurance contracts on the one hand and contracts of reinsurance, to which the parties are professionals in the market, on the other. That distinction was not lost on the Law Commission, to whose report the Vice-Chancellor refers. I cannot help wondering, however, whether he actually read the report prior to writing his judgment. For one thing, the Law Commission concluded that the recommendations made in their report (which were aimed primarily at protection of consumer interests) should not apply to contracts of reinsurance on the grounds, inter alia, that "the parties to such contracts are . . . aware of the well known and long standing rules of law and practice governing the market in which they operate; they will therefore not require the protection provided by our recommendations." For another, although the Law Commission did indeed discuss the introduction of a judicial discretion to provide for proportional, rather than all or nothing relief, their conclusion (in a paragraph cited specifically by the Vice-Chancellor) was as follows:

"A general judicial discretion would do not more harm than good. It would introduce an unacceptable element of uncertainty into the law . . . "

I rest my case.

THE SEALED OFFER IN ARBITRATION
by Julian Critchlow, Winward Fearon & Co.

Not so long ago two ladies who were wrongfully prosecuted by Tesco for alleged shoplifting themselves subsequently brought proceedings against Tesco for defamation. At trial both ladies established liability and were awarded modest compensation. However, a substantial proportion of the costs of the action, which were considerable, was ordered to be paid by the ladies to Tesco. As a consequence, both ladies were severely out of pocket and expressions of outrage at this presumed injustice appeared in the national press.

This upsurge of righteous indignation stemmed from a failure to appreciate the significance of the High Court process of the payment into court (which was operated by Tesco in this case) and which has a sister process, the sealed offer, which is applicable to arbitrations.

Purpose

The payment into court and sealed offer perform identical functions namely:

(i) the promotion of settlement;

(ii) provision of an opportunity to defendants in litigation, and to respondents in arbitration, to guard against costs liability in circumstances where the plaintiff's claim (in litigation) or claimant's claim (in arbitration) is excessive.

Costs

In order to appreciate the operation of sealed offers it is necessary to understand a little of the basis upon which costs are awarded. The award of costs is at the discretion of the judge in litigation and of the arbitrator in arbitration. However, that discretion must be exercised judicially and certain principles have evolved which must be adhered to in the absence of special circumstances. The most important of those principles is that costs "follow the event". That is, the losing