CAUDLE, COX AND AXA: THE YEAR OF THE EVENT

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Introduction:

The last three years have witnessed a proliferation of litigation arising out of contracts within the London reinsurance market. Up until that time, the number of reinsurance disputes that resulted in court proceedings and reported judgments were relatively few in number. Since then, however, matters which had previously been resolved by market practice have developed into issues that can only be decided by litigation and eventual judgment. The Commercial Court has taken a robust view and Commercial Court judges have shown a willingness to examine reinsurance wordings in great detail in an attempt to determine points of principle which would, in time, be of use to the market as a whole.

One particular issue that has warranted detailed consideration is aggregation of claims. The central question is whether the reinsured is entitled to aggregate its claims as one loss for the purpose of recovering under its reinsurance programme. Reinsureds will always consider how best to maximise reinsurance recoveries: most often, this will be done by aggregating claims and presenting the largest possible amount for recovery from reinsurers. The factors which would determine the reinsured's decision in this regard will clearly be the amount of the reinsured's deductible, and how that deductible is applied to the reinsured's claims under its reinsurance contract. Most important, will be the precise wording of the contract in respect of the reinsured's ability to aggregate its claims and on what basis these claims are to be aggregated.

Aggregation in Reinsurance Contracts

Aggregation is possible in reinsurance contracts in two broad categories: under a specifically worded aggregate extension clause or, in the absence of such a clause, under the wording of the contract itself.

Over the past 18 months, judges both in the Commercial Court and the Court of Appeal have been dealing with the latter situation and have involved themselves in a semantic exercise stretching the imagination of the most enthusiastic lexicographer. Three recent cases, arising from the Lloyd's litigation, specifically concern the rules

governing recovery of aggregate claims under reinsurance contracts. The three cases which are the subject of this article, all arise from the consequence of findings of negligence against Lloyd's underwriters.

Before examining these cases in detail, it is worth looking at part of the wording of a typical aggregate extension clause which provides coverage for claims by different insureds arising out of the same "cause". Its origin was the potential exposure faced by London underwriters for product liability arising out of a defective product that was widely distributed, such as the oil contaminating the Texas cattle feed. Its purpose was to allow claims on various different aggregate insurances arising as a result of one cause to be aggregated as one loss for reinsurance purposes.

The specific part of the clause provides as follows:

> *In circumstances in which one event or occurrence or series of events or occurrences originating from one cause affects more than one policy or contract issued to different insureds or reinsureds then, in such circumstances, a series of policies or contracts so issued shall be deemed to constitute one aggregate risk for the purpose of this reinsurance, provided that each policy or contract has inception during the period of this reinsurance. Nevertheless, in circumstances in which the policy or policies of more than one insured are involved in an aggregation of losses, only that part of the aggregation concerned with and originating from the one cause shall be considered as being covered by this reinsurance in respect of each and every loss.*

Two concepts which have provoked recent detailed consideration by the Courts are the two separate but possibly indistinct concepts, of event and cause. The aggregate extension clause uses the words "event" and "occurrence" interchangeably, but draws a distinction between both of these and "cause". Is there a sound linguistic basis for this distinction?

In search for the natural meaning of these words, the Shorter Oxford English Dictionary defines "event" as "something that happens or is thought of as happening; an occurrence, an incident". With admirable circular reasoning, the word "occurrence" is defined in the same work as "a thing that occurs, happens, or is met with; an event, an incident". The word common to both of these is "incidents" (a word not regularly used in reinsurance contracts) which itself is defined as "a distinct occurrence or event".

The definitions set out above do not indicate that there is any quantitative or temporal

distinction between the words "event" and "occurrence". Turning now to the dictionary definition of "cause" we see it is "that which produces an effect or consequence; an antecedent or antecedents followed by a certain phenomenon". This is of slightly more assistance, especially in the context of the aggregate extension clause, which seems to imply some temporal disjunction between "cause" and that which follows, possibly an event, occurrence or incident. The inference is strengthened by the use of the words "originating from one cause" in the aggregate extension clause which suggests that the cause must be a precondition to the happening of the events, occurrences or incidents.

How has this come to light in the context of reinsurance contracts? In the absence of an aggregate extension clause, aggregation of claims for the purpose of reinsurance recoveries is based on the wording of the reinsurance contracts. Here initial problems arise: have the drafters of reinsurance contracts ever paid heed to the precise semantic differences (if any) between the words "event", "cause" and "occurrence". A series of recent cases has brought this discussion into the limelight with differing and sometimes conflicting results.

Caudle -v- Sharp (Queen's Bench Division, 23 February 1994)

This case arose out of the writing by Mr Richard Outhwaite of "run-off" reinsurance contracts which eventually resulted in enormous losses. The Names on the Outhwaite syndicates brought an action alleging negligence by Mr Outhwaite in the writing of 32 contracts in the 1982 year of account. The action was settled, the Names accepting £116 million. Thereafter both the managing agents and the members agents claimed against their E&O insurers who, in turn, sought to recover from their reinsurers. The insuring clause of their reinsurance contracts read as follows:

> *This insurance is only to pay the excess of an ultimate net loss to the reinsured of £5 million or US or C$10 million each and every loss....for the purpose of this reinsurance the term "each and every loss" shall be understood to mean each and every loss and/or occurrence and/or catastrophe and/or disaster and/or calamity and/or series of losses and/or occurrences and/or catastrophes and/or disasters and/or calamities arising out of one event.*

Reinsurers (led by Mr Caudle) said that they had no liability: Mr Outhwaite was negligent each time he wrote one of the 32 contacts and the loss did not arise out of

one event but out of 32 separate events. The claims failed as they did not exceed the financial limits in the insuring clause. Understandably, Mr Sharp disagreed with this interpretation and the matter went to arbitration.

The arbitrators considered, in some detail, the definition of the word "event", providing perhaps the most detailed, at that time, analysis of this point. They began from the premise that an event is something fixed and definite in time and space but can vary as to its magnitude. A one day gymkhana is a minor event, whereas in an historical context, the Second World War is a major event. It would also be possible for an event to embrace within it a number of smaller events such as Pearl Harbour and D-Day, both being events arising out of the Second World War, which in itself is a larger event. In the context of the facts at issue, the arbitrators sought to establish that the losses suffered arose from a particular and identifiable "event" on the part of Mr Outhwaite. In doing this, the arbitrators introduced the concept of "act" which they equated, in semantic terms, with "occurrence" or "event". The act, they determined, was Mr Outhwaite's negligence in the writing of the original contracts by reason of his failure to conduct the necessary research and investigation into the basic underlying problem of asbestosis. That act was the occurrence giving rise to the series of losses under the policies, and must therefore constitute the "event" under the insuring clause.

Linguistically, the arbitrators have performed gymnastic feats, contorting the supposed meanings of "act", "occurrence", and "event" into one amorphous whole. Underlying all of this was the arbitrators' acceptance of the paradox that the "act" (Mr Outhwaite's state of mind) was actually an omission, and that, in itself, was an intangible, unquantifiable either in extent or time.

The arbitrators' award was immediately appealed to the Queen's Bench Division where it was considered by Clarke J. The basis of reinsurers' appeal was that a state of affairs is not an event and nor (without more) is a failure to do something. Clarke J., although admitting this was not an easy problem, found it relatively easy to agree with the arbitrators that the making of each contract arose out of one event, namely the same continuing failure of Mr Outhwaite to take proper steps. He saw that the loss comprised a series of occurrences (the writing of 32 contracts) which arose out of one event (Mr Outhwaite's continuing failure). Clarke J. was, in addition, content to conclude that his finding was consistent for the purpose of the reinsurance contracts: to protect the Sharp syndicate against large losses arising out of a common

cause or event. Clarke J. was not tempted into any comment on a definition of "cause", perhaps rightly so, given that this word did not appear in the insuring clause of the contracts which were the subject of the action.

Generally, rules of contract construction provide that where different words are used in the same clause or document, it will be assumed that they are intended to have a different meaning. The market seems to have demonstrated a consistent intention that, for insurance purposes at least, "event" is deemed to have a wider meaning than "occurrence" so that an occurrence, or several of them, might be comprised in a single event. The wording of the clause in issue in this case did not, unfortunately, allow the court to address the meaning of "cause" in this context.

Cox -v- Bankside (Queen's Bench Division, Commercial Court, 27 January 1995)

This case, brought in the Commercial Court before Phillips J., is a product of the Lloyd's litigation. The case evolved from the action by members of the Gooda Walker Action Group against the Gooda Walker Agency and its underwriters. Phillips J. gave judgment in this action in October 1994, holding that the Names had established that three of the Gooda Walker underwriters and vicariously, their managing agency, were liable arising out of shortcomings in the conduct of underwriting and subsequently ruled on quantum. This decision sparked a flurry of legal activity as the Names quickly realised that there was a realistic chance that neither Gooda Walker (which was in liquidation) nor its E&O underwriters would have the resources to satisfy all or even most of the amount awarded in damages. The result was an originating summons by the E&O underwriters of Gooda Walker seeking to resolve a number of issues which would determine how the E&O policies would respond. The plaintiffs, led by Mr Cox, were the E&O underwriters, whereas the defendants were the agents and the various groups of Names involved in the Lloyd's litigation, which comprised about 50 actions at that time.

Phillips J.'s decision at first instance is an admirable attempt to marry strict principles of recoverability of damages to the situation engendered by the unique circumstances of the Lloyd's insurance market, and the Names' litigation. The originating summons procedure was the product of an agreement between all interested parties, as well as the Judge to provide a mechanism for distribution of the payments under the E&O policies amongst those entitled to them. At issue, therefore, were specific questions as to the construction of the E&O policies. One

of these is particularly relevant to this article: "if the liability established in *Deeny -v- Gooda Walker Limited* arises from more than one originating cause, how many?"

This case is simlar in emphasis to the issues in *Caudle -v- Sharp:* Phillips J. was asked, by the above question, to make a declaration as to aggregation of claims to the E&O policies. The relevant insuring clauses (in those policies without an aggregate extension clause) referred to aggregation in terms of "any one occurrence or series of occurrences arising from one originating cause". Phillips J. was not required to distinguish between "originating cause" and "event" but to consider further what the nature of an originating cause may be in the context of these E&O policies.

In argument, the E&O underwriters relied heavily on the judgment of Clarke J. in *Caudle -v- Sharp* which had not, by this stage, reached the Court of Appeal. They made an admirable attempt to stretch Clarke J.'s conclusion to its utmost elasticity by submitting that there was but one originating cause of the liability, being lack of any proper formulation and implementation of underwriting policy at the level of the Gooda Walker board. An alternative submission, only slightly more credible, was that lack of appreciation of the effect of the spiral was the single originating cause responsible for all the Gooda Walker losses, in the same way that Mr Outhwaite's lack of appreciation of the consequences of asbestosis was the single event which caused the losses that flowed from the 32 run-off contracts in *Caudle -v- Sharp.*

The contrary submission by the defendants was that at least three originating causes applied, based on the negligence of the individual underwriters responsible for underwriting on three of the Gooda Walker syndicates.

Phillips J. had no difficulty in being persuaded by the defendants and made his decision in line with Clarke J. in *Caudle -v- Sharp.* He held that the approach to underwriting of each underwriter was a separate originating cause, resulting in the losses suffered by the Names on whose behalf that underwriter was writing business. There were, therefore, three originating causes for the purpose of E&O coverage.

Whilst this decision adds little, if anything, to the linguistic construction of "cause" and "event", Phillips J. falls squarely in line with Clarke J., essentially equating "originating cause" with Clarke J.'s definition of "event" in the context of the Names litigation. Whilst, however, allowing that the state of mind of a negligent underwriter could constitute an "originating cause" Phillips J., perhaps sensibly, stopped short of

extending this to cover the state of mind of a corporate entity. *Cox -v- Bankside* went to the Court of Appeal, but no question was placed before their Lord Justices arising out of that part of Phillips J.'s decision. The Court of Appeal, consequently, took the matter no further in this case.

Caudle -v- Sharp (Court of Appeal, 11 April 1995)

Shortly after the decision in *Cox -v- Bankside* this case reached the Court of Appeal. The essential question before the Court was whether Mr Sharp could aggregate the losses of the 32 contracts under the contract definition of "each and every loss arising out of one event".

The Court of Appeal appears to have been aware of the dangers of construing the word "event" in such a way as to interpret the policy as though it contained an aggregate extension clause. They rejected the interpretation that a state of affairs, namely Mr Outhwaite's continuing failure to act with necessary prudence, could be an event and held that each of the 32 contracts was an event for reinsurance purposes. Aggregation was not, therefore, available on the basis suggested by Clarke J.

Evans L.J., giving the leading judgment, defined "event" as having three requirements:

i. a common factor which can properly be described as an event; It was clear that each of the 32 contracts was an occurrence. Could those 32 occurrences be aggregated into a single event? The Court of Appeal thought not. Evans L.J. rejected the finding that a "blind spot" could amount to an event. He, therefore, found that each of the 32 contracts was separate and there was no sufficient common factor to deem them the result of one event.

ii. that factor must satisfy the test of causation; the relevant clause required losses to "arise out of" a single event. Evans L.J. held that those words were wider than the causation required under the original E & O policy: the reinsured's loss is by its nature different from the insured's. But there needs to be an event. In this case there was not.

iii. that factor must not be too remote for the purposes of the clause. If there had been an event, it should not be too remote from the losses. Evans L.J. (developing a theme introduced by the arbitrators) referred to the Second World War and the individual battles arising out of it: for reinsurance purposes at least,

the war would not be an event due to the remoteness of the battles.

This decision thwarted what may have been seen as an attempt to aggregate independent events without an aggregate extension clause. It also cures the paradox furthered by Clarke and Phillips JJ. The decision does not, unfortunately, assist further with pinning down any distinction between "cause" and "event".

***Axa Re Insurance (UK) Limited -v- Field* (Court of Appeal, 10 October 1995)**

The reinsurance aspect of *Cox -v- Bankside* fell clearly for decision by the Court of Appeal in *Axa Re -v- Field*. This, too, was an action by way of originating summons, seeking a ruling on the extent of reinsurers' liability to the E&O underwriters established by Phillips J. in *Cox -v- Bankside*.

The insuring clause in the reinsurance contract, the subject of *Axa Re -v- Field*, employed a different wording from that in *Cox -v- Bankside*, defining "each and every loss" as "every loss and/or occurrence...arising out of one event". This led to the essential question to be decided by the Court of Appeal: can "one event" in the reinsurance contract be construed in the same way as "one originating cause" in the underlying E&O policy? This is tantalisingly close to the essential question that should have been, but was not, answered by Phillips J. in *Cox -v- Bankside*. In this context, the question was not so much a linguistic examination of "event" and "cause", but rather a consideration of the effect of the "follow the settlements" clause which made all loss settlements by the reinsured unconditionally binding upon reinsurers.

In the event, Staughton L.J. did not allow himself to be drawn into a detailed analysis of "event" and "cause" and held, somewhat predictably, that an event is a happening or an occurrence; and it may include an omission. By itself, it is not necessarily a cause; but an event out of which something arises must be a cause. He then went on to hold that there was no relevant difference between "event" in the reinsurance contract and "originating cause" in the underlying policy. Axa Re, therefore, was bound by Phillips J.'s conclusion that there were three events out of which all the agents' claims arose.

This decision is perhaps confusing in a number of respects, none the least that the Court of Appeal has not made any clearer the fundamental question raised in *Caudle -v- Sharp* as to a workable distinction between "cause" and "event". Staughton L.J. did, however, approve of the tripartite definition of "event" provided by his brother

Evans L.J. in *Caudle -v- Sharp* and it is there that the law on this point currently rests. Staughton L.J. himself did not draw any distinction between the meaning of these words, nor comment on their application to reinsurance recoveries, an approach that does little to advance the possibility of some resolution to this debate. The Court of Appeal has, arguably, sought the most workable commercial solution to an obvious problem at the possible expense of strict interpretation of the policy wording. The Court was afforded an effective tool to achieve this by the presence of the follow the settlements clause. Clear evidence of this is found in Staughton L.J.'s utterance:

> *the huge capacity of the Lloyd's market to spawn litigation has become all too obvious in recent times. Where there is an attempt to restrict it, as in the follow the settlements clause, it should receive full faith and credit from the Courts.*

The Court of Appeal judgment in *Axa Re -v- Field* may, therefore, be seen more as an attempt to seek a commercial solution to an aspect of the Lloyd's litigation, rather than seeking finality on a fundamental point of construction of reinsurance contracts. This, perhaps, follows a trend established in the Commercial Court and evidence in some of the more recent judgments in reinsurance matters. The matter, ultimately rests in the hands of the House of Lords who will be hearing the appeal from the Court of Appeal's decision in *Axa Re -v- Field* in spring 1996.

Conclusion

The aggregate extension clause, therefore, remains as enigmatic as it was before all this litigation, and the fundamental questions are yet to be answered. Each of these cases has taken a bite from the apple but the core is yet to be exposed. It seems clearer and clearer that judges in the Lloyd's litigation strive to seek commercially workable solutions at the expense of useful precedents: a judicial false economy that will hopefully be redressed by the House of Lords in *Axa Re -v- Field* later this year.

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