CHARTER RE -v- FELTRIM

by Nigel Brooke

In May the House of Lords unanimously concluded that payment of a loss is not a pre-condition to recovery under an excess of loss reinsurance, in spite of the reference in the Ultimate Net Loss clause to the "sum actually paid". This is a very important decision in its own right, not least because of the amount of reinsurance recoveries riding on it. But it also offers an insight into the Courts' attitude towards the reinsurance market and its practices, and their approach to difficult questions of interpretation.

As recently as 1980 the body of reinsurance caselaw in England was thin and patchy. Many major issues of principle remained unexplored; most standard clauses had not been tested. The reinsurance community tended to resolve disputes amicably, or through private arbitration, resorting only rarely to the Courts.

The position has altered radically. Reinsurance decisions are now commonplace and this Spring three reinsurance cases (including *Charter Re -v- Feltrim*) went before the House of Lords in the space of a month. Counsel at the commercial bar with direct experience of reinsurance disputes have been making their way onto the bench for some years now. So the market might expect a growing awareness, in the Commercial Court and above, of the way they do business.

On some issues, such as "follow settlements", the Courts have shown a real awareness of the market's workings. Nonetheless, several times in recent years the Courts have taken one section or another by surprise. For example, many professional indemnity insurers are disappointed that the concept of "event" has been given a relatively narrow interpretation in *Caudle -v- Sharp* and, recently, by the House of Lords in *Axa Re -v- Field.* Reinsurers are correspondingly surprised by the broad interpretation of the Aggregate Extension Clause in *Denby -v- Marchant.* Each of these groups felt - rightly or wrongly - that their broad intentions and their previous dealings had not been given sufficient weight and that the Courts had adopted an unduly legalistic, or simplistic, approach.

Sometimes the main objective in taking a reinsurance dispute to Court rather than arbitration is to establish a precedent. A legal decision crystallises the

issues and gives parties a better understanding of their rights and obligations. But there is a feeling in some quarters that legal decisions on market issues can do more harm than good. This is because understandings and expectations have developed over the years in the London market, and these are sometimes at variance with the strict terms of the contract wording. So for example reinsurers have for years given a relatively broad meaning to the concept of "event" in the professional indemnity field, knowingly and willingly going beyond the strict dictionary definition of the term. This pragmatic approach created an expectation on the part of cedants, an expectation which may not have been fulfilled by recent decisions.

This leads us on to Charter Re. The case centred on a clause which (with small variations) has been in near-universal use in excess of loss reinsurances for over 60 years. The main purpose of the UNL clause is to determine the size of the loss per event, to which the excess point and limit are applied. It typically reads as follows:

> *"The term 'Net Loss' shall mean the sum actually paid by the Reinsured in settlement of losses or liability after making deductions for all recoveries, all salvages and all claims upon other Reinsurances whether collected or not and shall include all adjustment expenses arising from the settlement of claims other than the salaries of employees and the office expenses of the Reinsured.*
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> *All Salvages, Recoveries or Payments recovered or received subsequent to a loss settlement under this Reinsurance shall be applied as if recovered or received prior to the aforesaid settlement and all necessary adjustments shall be made by the parties hereto. Provided always that nothing in this clause shall be construed to mean that losses under this Reinsurance are not recoverable until the Reinsured's Ultimate Net Loss has been ascertained".*

Here was a case which perfectly illustrated the contrast between the two schools of thought: the literalist versus the pragmatic. The literalist view was that the phrase "sum actually paid" had only one possible meaning - "we respond to your payments" - and the process of interpretation ended there. The pragmatic view was that, whatever the words might mean, this could not possibly have been intended because the consequences would be so extreme - in particular, insolvent

reinsureds would recover little or nothing from their excess of loss reinsurers, and so creditors would receive much smaller dividends. It appears that the DTI was part of the pragmatic school, since it has historically allowed insurance companies to take credit for prospective XL recoveries in assessing their solvency - something which would not make sense if such recoveries depended on the company's solvency rather than the other way around.

The literalist view was put with great force and clarity by Staughton LJ in the Court of Appeal. His approach was to *"consider what the contracts say on the literal meaning of their wording, and how clearly they say it; and then whether that meaning would be unreasonable, and if so how unreasonable"*. He had no doubt that the contracts, literally interpreted, made reinsurers liable only for the sums actually paid by the reinsurers. He also considered that there was no evidence to support the argument that this interpretation was unreasonable, or was one which the parties were clearly seeking to avoid. It was not legitimate, he said, to take account of any impact the decision might have on the solvency of other insurance companies: *"...it is not the task of the Courts to interpret private contracts in such a way as to ensure that the national interest is well served"*.

In conclusion he commented:

> *"This dispute is about the meaning of two words, "actually paid". There must come a time when efforts to bend meaning (or, as I would say, reverse it) have to stop. The literal meaning of the words in the contract requires that the insurers shall have paid before the reinsurers are liable. To the extent, if at all, that this produces a result which is unreasonable, it is not so unreasonable that it requires us to depart from the plain meaning of the words. Indeed I doubt whether it is unreasonable at all"* ((1996) 2 WLR 726 at 746).

The literalist approach espoused by Staughton LJ has a strong virtue: predictability. If Courts invariably gave words their ordinary and natural meanings, without excessive attention to the wider consequences, then there would be less scope for disputes; parties would know where they stood.

But this takes scant account of the way business is conducted in the reinsurance market. Its practitioners are quite used to giving strained meanings to words.

For example, it is standard practice in excess of loss contracts to impose a limit per event and allow cover to reinstate a fixed number of times - "$1m excess of $500,000 each and every loss, two free reinstatements". These words could readily be interpreted as saying that the contract will respond to a maximum of three events, and will not respond to a fourth, even if the contract has not paid $3m. Anyone in the reinsurance market would know that this was not what was intended by the words, which are a shorthand way of expressing an aggregate limit. But a literalist could reply that, if that is what the parties intended, then they should have said so in terms.

Staughton LJ had thrown down a challenge: just how far are the Courts prepared to go in bending words to achieve a commercial end? The House of Lords did not meet this challenge head on. Lord Mustill, giving the leading judgment, conceded that at first sight he shared Staughton LJ's view as to the clear meaning of the phrase "actually paid". But he concluded that, when the contract was read as a whole, the purpose of the key terms became quite clear:

> *"...I am now satisfied that the purpose of "the sum actually paid"...is not to impose an additional condition precedent in relation to the disbursement of funds, but to emphasise that it is the ultimate outcome of the net loss calculation which determines the final liability of the syndicates under the policy. In this context, "actually" means "in the event when finally ascertained", and "paid" means "exposed to liability as a result of the loss insured under clause 1". These are far from the ordinary meanings of the words, and they may be far from the meanings which they would have in other policies, and particularly in first-tier policies of reinsurance. But we are called upon to interpret them in a very specialised form of reinsurance...".*

This passage is interesting for a number of reasons. First, it underlines the fact that Lord Mustill did not want to be seen to go very far outside the contract in reaching his conclusion - though, having reached it in this way, he derived comfort from the wider consequences in the market. Secondly, he was at pains to emphasise that he was not seeking to establish a wider precedent; the case turned on the fact that it related to LMX contracts (although that is not explicitly mentioned in the judgment). Thirdly, in reinforcing this point, Lord Mustill hinted strongly that the outcome could well have been different if the same

phrase - indeed, the same contract wording - had appeared in a *"first-tier"* reinsurance contract, by which he presumably meant a reinsurance of a direct insurer.

All of this indicates that Lord Mustill was very keen to uphold an insolvent company's right to recover in full from its reinsurers, whilst doing the minimum possible injury to the accepted principles of interpretation. Echoing Staughton LJ's words he commented:

> *"There comes a point at which the Court should remind itself that the task is to discover what the parties meant from what they have said, and that to force upon the words a meaning which they cannot fairly bear is to substitute for the bargain actually made one which the Court believes could better have been made. This is an illegitimate role for a Court".*

He expressly acknowledged that he might well have been forced to follow Staughton LJ's judgment, *"austere as it might seem"*, if the key phrase had only been capable of the one meaning.

In the United States some judges would not have felt restrained in this way, particularly in cases involving protection of the consumer. US Courts have been known to find an ambiguity where none exists in order, effectively, to re-write the parties' bargain and achieve a particular commercial outcome. London insurers have seen this happen repeatedly in relation to the standard "sudden and accidental" pollution exclusion.

There is no evidence that this full-blooded "public policy" approach is gaining ground in the English Courts. Nonetheless, for all its provisos and caveats, Lord Mustill's judgment is a striking example of the purposive approach to interpretation. Although he could not concede that it influenced his decision, he was well aware of the profound consequences of following the literalist line. A point he must surely have had in mind is that for many years reinsureds, reinsurers and the DTI acted on the assumption that payment was <u>not</u> a pre-condition to recovery from excess of loss reinsurers.

The decision involved an insolvent company, but it is of more general application. So in principle a solvent reinsured could force its reinsurers to pay while delaying payment up the line - provided of course that it had itself become

liable to pay a specified sum. This might have struck the House of Lords as repugnant if it had arisen as an issue in the case, but it would have been impossible to interpret the UNL clause in such a way as to distinguish between the "can't pays" and the "won't pays". That could only be achieved by re-drafting. As it happens that task is under way, and the market should soon have a revised UNL clause designed to be used alongside an insolvency clause. Taken together these should enshrine the current position in relation to insolvent reinsureds (that is, liability in an ascertained amount is enough to trigger a reinsurance recovery), and at the same time make it crystal clear that a solvent reinsured must pay before it can recover.

Some reinsurers might be inclined to go further and redraft the UNL clause in such a way that their liability is limited in all circumstances to the sum paid by the reinsured - the position argued for by the reinsurer in *Charter Re*. There is no doubt that this can be achieved by sufficiently clear words, as Lord Mustill acknowledged. But the resulting cover would be unmarketable. The DTI is now alert to the issue and it would simply refuse to take account of such a cover when assessing the reinsured's solvency. No broker could sensibly advise his client to accept a wording along those lines. Indeed the existing UNL clause is no longer a safe option for buyers of "first-tier reinsurance" in the light of Lord Mustill's remarks.

The reinsurance market has a marked reluctance to change standard clauses. The UNL clause is now to be altered but only in the light of a House of Lords decision, and some seven years after the point first arose in *Home & Overseas - v- Mentor*. If there is a general lesson from recent Court decisions on reinsurance issues, it is that the market's unwritten expectations and understandings will often be confounded. The Courts simply look at wordings in a different way. *Charter Re* was exceptional in that the House of Lords bent over backwards to meet the market's expectations, in the teeth of the words used. For the future it is safest to assume that this will not happen, and act accordingly.

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