1996: IS THERE A THEME?

by Steven Fox and Jan Heuvels

The shake up of the London and in particular Lloyd's reinsurance market in the last few years created an environment of confrontation between contracting parties fighting for survival in a rapidly shrinking market. In cases where in the past the parties would have tended to resolve disputes amicably or through private and confidential arbitration, commercial pressures were such that they were forced to resort to drawn out litigation in the public forum of the Courts. As a consequence, Lloyd's almost collapsed and the market as a whole suffered long term damage to its reputation whilst the body of reinsurance case law in England has grown substantially.

Many major issues of principle were determined and standard clauses were interpreted by the Courts at all levels. The benefit of these decisions must be judged not only against the specific background of the case in question or even the problems of the present market but also the potential difficulties facing the market in the future; after all, from a commercial point of view many of the decisions were merely a post mortem for a large number of syndicates and companies.

The past year will go down in history as the year in which the commercial and legal debate culminated in R&R and three pivotal judgements of the House of Lords in ***Charter Re v Fagan*** [1996] 2 LLR 113, ***Axa Re v Field*** [1996] 1 LLR 26 and ***Hill v Mercantile & General*** [1996] 1 WLR 1239. The leading judgement in all three cases was given by Lord Mustill.

Charter Re v Fagan

The case centred on the interpretation of the "ultimate net loss" ("UNL") clause and in particular whether it imposed a condition precedent of payment by the reinsured of the underlying claim prior to recovery under the reinsurance, subject, of course, to the other terms and conditions of the reinsurance contract.

The House of Lords held unanimously that the words 'actually paid' in the UNL clause did not impose a condition precedent to recovery by the reinsured to the

effect that the reinsured must first have discharged its liability to the original insured by transferring funds, before being entitled to make a claim against the reinsurers under the reinsurance contracts. The leading judgment was given by Lord Mustill. The other Law Lords agreed, Lord Hoffman giving a separate but concurring speech.

Lord Mustill did not conceal that, at first sight, he had concluded that the words 'actually paid' meant that the reinsured would have to suffer some *'financial detriment through the transfer of funds'* to the original insured before being able to make a claim under the reinsurance contracts. However, he then went on to state that this was *'an occasion when a first impression and a simple answer no longer seem the best, for I recognise now that the focus of the argument is too narrow. The words must be set in the landscape of the instrument as a whole'.*

Looking at the policy wording as a whole he decided that the purpose of the UNL clause, which contained the words 'actually paid', was to make it clear that the reinsurers' obligation to indemnify the reinsured must be determined by reference to that reinsured's 'net' liability, ie. after taking into account recovery and salvage. Lord Mustill observed that only two conditions had to be met before the reinsured was entitled to an indemnity under the reinsurance contracts. These conditions were *'first that an insured event shall have occurred within the policy period, and second, that the event shall have produced a loss to Charter Re of a degree sufficient, when ultimately worked out, to bring the particular layer of reinsurance into play*'. The words 'sum actually paid' did not impose a third condition but instead emphasised that it was the ultimate outcome of the net loss calculation which determined the final liability of the reinsurers. Consequently, in this context *'actually'* meant *'in the event when finally ascertained'* and *'paid'* meant *'exposed to liability as a result of the loss insured'.*

Lord Mustill conceded that the meaning he had given to these two words was far from the ordinary meaning of the words and far from the meaning they may have in other policies for example so called *"first-tier policies of reinsurance".* However, in the context of this very specialised form of reinsurance, he was satisfied that Mr Justice Mance's judgment was correct. Whilst stressing that the interpretation of the policy wording had led to the above conclusion, Lord Mustill also agreed that the imposition of a pre-condition of pre-payment by the reinsured would *'bear especially hard on Charter Re, if it fell into trouble and*

lacked the means to make the payments necessary to unlock the reimbursements due under its contracts with the Syndicates [reinsurers]'.

As regards the notion of words having a natural meaning, Lord Hoffman stated that *'the notion of words having a natural meaning is not a very helpful one. Because the meaning of words is so sensitive to syntax and context, the natural meaning of words in one sentence may be quite unnatural in another. Thus a statement that words have a particular meaning may mean no more than that in many contexts they will have that meaning. In other contexts their meaning will be different but no less natural'.*

Axa Re v Field

The case has its origin in the Gooda Walker litigation and the subsequent dispute between the Gooda Walker Underwriting agents and their E&O Underwriters in ***Cox v Bankside.*** In ***Deeney v Gooda Walker Ltd*** a large number of Names at Lloyd's, forming part of the Gooda Walker Syndicates, brought successful claims against their Lloyd's Underwriting agents on the basis that there had been many instances of negligent underwriting by the agents which caused substantial losses to the Syndicates and their members.

The Defendant Underwriting agents were insured against these losses under E&O policies. One of the Defendant Underwriting agents, the Bankside Members Agency Limited, brought a test case against its E&O reinsurers, including the Cox Syndicate (204). One of the issues resolved in those proceedings was how various acts and omissions which founded the liability of the Members' agents could and should be aggregated under the Members' agents' E&O policies. The relevant part of the E&O policies contained a maximum insured sum for a ***"series of events or occurrences attributable to one originating cause".***

The Cox Syndicate in turn looked to recover at least part of these losses under its excess of loss reinsurance treaties written by, among others, Axa Re. The main issue was how aggregation should take place in the context of these excess of loss reinsurances which included aggregating provisions by reference to a "***series of ... occurrences ... arising out of one event***". The Cox Syndicate argued that the phrases 'originating cause' and 'one event' meant the same and that,

therefore, aggregation under the excess of loss reinsurances should follow the aggregation under the underlying E&O policies. Mr Justice Phillips at first instance and the Court of Appeal agreed.

The House of Lords gave judgement less than a month after its findings in ***Charter Re v Fagan***. Their Lordships unanimously reversed the decision of the Court of Appeal. Lord Mustill (with whom the other Law Lords agreed) disagreed with each of the themes on which the Court of Appeal had based its decision.

1. The assumption of 'back-to-back' cover: whilst applicable in the context of proportionate reinsurance under which the reinsurer is sharing the risk assumed by the direct insurer, this was not applicable in the context of excess of loss reinsurance. Lord Mustill stated that *'where a reinsurer writes an excess of loss treaty for a layer of the whole account (or the whole of a stipulated account) of the reinsured... [*there was*] no reason to assume that aggregation clauses in one are intended to have the same effect as aggregation clauses in the other. The insurances are not in any real sense back-to-back.'* Consequently, it was not possible to start the enquiry into the meaning of the two phrases by assuming that the parties intended the provisions for aggregation in the direct policy and in the reinsurance treaty to be the same. The natural way to achieve that result would be to make sure that the aggregation clauses are the same.

2. The assumption that limiting terms in reinsurance clauses should not readily be found to operate more stringently than those in the underlying policy: Lord Mustill commented that he was not sure that this proposition could actually be found in the judgment of Hirst LJ in ***Hill v M&G***. However, in any event he did not agree with it as he could *'visualise no good reason why the meaning of a clause in one of the direct policies, or even for that matter of a clause common to all the direct policies, should necessarily fix the outer limits of the aggregation under the reinsurances.'*

3. Lord Mustill agreed that contracts of insurance/reinsurance should not be interpreted in the manner of a philologist or a pedant. However, poor

drafting should not be equated with poor thinking and consequently Lord Mustill was *'wholly unwilling to start from an assumption that those who drew up these clauses were so indifferent to their meaning that whatever words were used the intention was in every case much the same'.*

Having set aside the above 'preconceptions' Lord Mustill expressed the view that the answer was straightforward. The only safe course was *'to fall back on the words actually used, and to read them as they stand'.* Relying on the ordinary meaning of the words, Lord Mustill held that:

a. An event is something which happens at a particular time, at a particular place, in a particular way.

b. A cause is altogether less constricted. It can be a continuing state of affairs; it can be the absence of something happening.

c. The word 'originating' opens up the widest possible search for a unifying factor in the history of the losses which it is sought to aggregate.

Lord Mustill expressed regret that ***Cox v Bankside*** itself was not being appealed in this action not because he suspected that ***Cox v Bankside*** may not be right (on which point he expressed no opinion whatever), but because in the long run it might have been more helpful for the House of Lords to look at the whole matter afresh and, after reviewing the principles, for the House to decide how the aggregation should work in the present case, and why. However, this was not what the court had been asked to do.

Hill v M&G

The case centred on the interpretation of follow the settlements clauses which are frequently found in reinsurance contracts. The facts were these.

On 2nd August 1990 Iraqi troops invaded Kuwait and took possession of a number of aircraft including fifteen aircraft belonging to Kuwait Airways Corporation ('KAC') and one to British Airways ('BA'). All fifteen KAC aircraft were flown out of Kuwait to Iraq in August and September 1990. The single BA

aircraft remained at Kuwait airport up to the end of the war but was destroyed on the runway in an explosion on 22nd February 1991.

KAC and BA were insured under war risk policies and made claims. KAC's insurers, the Kuwait Insurance Company ('KIC'), paid them US$ 300 million being the maximum sum insured in respect of ground risk in relation to any one occurrence. KAC accepted the payment without prejudice to their contention that there were fifteen separate occurrences, one in respect of each aircraft. KAC also raised an issue as to whether the settlement had been properly allocated to the reinsured policy year which can, however, be ignored for the purpose of the present discussions. Mr Justice Rix had held earlier that there was only one occurrence so that, subject to any appeal, the US$ 300 million payment exhausted the policy limit. The primary insurers were reinsured. The immediate reinsurers had taken out excess of loss reinsurance in the London market and those reinsurers were in turn reinsured (the infamous LMX spiral). Hill was one of the immediate reinsurers and M&G was one of Hill's excess of loss reinsurers.

The reinsurance contracts contained follow the settlements clauses providing:-

> *"All loss settlements by the reassured including compromise settlements and the establishment of funds for the settlement of losses shall be binding upon reinsurers, providing such settlements are within the terms and conditions of the original policies ... and within the terms and conditions of this reinsurance."*

The House of Lords had to decide the ambit of this clause. Should the clause be given a wide interpretation requiring the reinsurers to follow settlements made down the line save in very exceptional circumstances or should it be construed narrowly, leaving reinsurers free to argue defences based on issues of law and/or fact. M&G argued in favour of a narrow interpretation but the Court of Appeal rejected reinsurers' contentions stating that they were bound to follow the settlements of the reinsured as long as the loss was of the type covered by the reinsurance.

Again, Lord Mustill fundamentally disagreed with the court below. He highlighted what he called the 'two provisos' in the follow settlement clause namely that the reinsurer cannot be held liable unless the loss (i) falls within the cover of the underlying reinsured policy and (ii) is within the terms of the reinsurance policy.

> *"To my mind these draw a distinction between the facts which generate claims under the two contracts and the legal extent of the respective covers; the purpose of the distinction being to ensure that the reinsurer's original assessment and rating of the risks assumed are not falsified by a settlement which, even if soundly based on the facts, transfers into the inward or outward policies, or both, risks which properly lie outside them."*

Lord Mustill stressed the importance of the terms of the bargain between the reinsured and the reinsurer and that the above mentioned 'provisos' operated to ensure that reinsurers could not be made to provide cover outside those terms. The significant distinction drawn by Lord Mustill is between the facts of the loss and the terms of the coverage of the insurance and reinsurance contracts. The reinsurer is bound by the factual determinations made by the underlying insurer in, for example, assessing the nature, size and timing of the loss provided such determination is made in good faith and in a business-like manner (the essence of the previous judgement of the Court of Appeal in ***INA v Scor*** [1985] 1LLR 312). However, legal points of coverage under the reinsurance contract (eg different coverage triggers or exclusions compared with the underlying cover) will remain open and in order to be able to recover under his protection the reinsured must show that the loss falls within the terms and conditions of the reinsurance contract.

Commentary

Some say that the three judgements have a consistent theme; the contractual autonomy of the reinsurance contract. This, it is said, is a welcome reversal of the previous tendency by the Courts to view reinsurance contracts merely as an extension of the underlying insurance policies. If this means no more than that the House of Lords reversed (and in the case of ***Charter Re*** confirmed) the Court of Appeal then the previous theme was extremely short-lived.

The existence of such a theme and its suggested reversal must be considered in the context of the nature of the reinsurance contract itself. In each case the House of Lords considered non-proportional treaty reinsurance (ie excess of loss) and different considerations will almost certainly apply in the context of proportional treaty reinsurance or indeed facultative reinsurance.

It is much easier to see how such a theme can be found in ***Axa Re v Field*** and ***Hill v M&G*** as opposed to ***Charter Re v Fagan***, which depended solely on the interpretation of the UNL clause in the reinsurance contract. Also, it may be unsurprising to find the same theme in ***Axa Re v Field*** and ***Hill v M&G***. The appeals in both cases proceeded together as both cases depended on the interpretation of the relationship between the underlying cover and the reinsurances. Lord Mustill was ultimately able to decide ***Axa Re*** without reference to the follow the settlements clause (a point which he himself stressed). However, his decision in ***Axa Re*** can also be viewed as an example of his interpretation of the follow the settlements clause in ***Hill v M&G.***

Another theme would be the Court's current approach to the construction of contracts and in particular reinsurance contracts. The House of Lords confirmed that the follow the settlements clause cannot be used as an aid to construction to the effect that the meaning of a provision in a reinsurance contract necessarily follows the meaning of a similar but not identical provision in the underlying contract. However, ignoring the pros and cons of the actual decisions themselves, the difficulty is that no consistent theme on 'construction' developed. On the contrary, the purposive approach in ***Charter Re*** was in sharp contrast to the literal approach in ***Axa Re*** less than four weeks later.

The theme that appears to emerge is that English Courts will give words their natural meaning only if to do so would produce a fair result in the eyes of the Court. On the other hand, as in ***Charter Re,*** the Court will make every effort to bend the meaning of the words if it considers that only a purposive approach will produce what is perceived to be a fair result. Staughton LJ (dissenting in the Court of Appeal in ***Charter Re***) would appear to be in the minority when expressing the view that "there must come a time when efforts to bend the meaning [of words] have to stop". The theme that emerges is not welcome; it lacks certainty and as economists have recently discovered, legal certainty is one of the prerequisites of efficient free markets.

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