Cut-through Clauses

by Christopher Braithwaite

Introduction:

It is often said that cut-through clauses are unenforceable under English law. As a general statement of the current law this is probably true. There are often, however, good commercial reasons for wanting to enter into arrangements of this kind, for example where the insurance company is fronting for a reinsurer. Cut-through clauses are now enforceable in some other jurisdictions and English law may have to follow suit. This paper examines (1) the nature of cut-through clauses, (2) their enforceability under English, US and Australian law, (3) a recent judgment of the English Court which suggests that in certain circumstances payments may be made by a reinsurer which by-pass an insolvent insurance company and (4) the future for these arrangements under English law.

1. Nature of cut-through clause

A cut-through endorsement or clause is a provision in a contract of insurance which typically purports to afford protection to a policyholder against the insolvency of its insurer. They may also be found in contracts of reinsurance and retrocession but this paper focuses on them from the point of view of a policyholder. The policyholder is given the right in these circumstances to claim directly against the reinsurer(s). Assuming the claim is valid, the reinsurer(s) agree to make payment of the reinsurance policy proceeds direct to the policyholder. The liquidator of the insolvent insurance company receives nothing under this arrangement. The issue which arises for the policyholder is the value of this so-called "right". Is it enforceable? From the point of view of the reinsurer(s) the issue is whether or not payments can be made direct to the policyholder without any risk of liability to the liquidator (ie. double liability). A further concern is that by accepting direct responsibility to an insured, the reinsurer may be said to be acting as a direct insurer. If so, this would give rise to serious regulatory concerns for the reinsurer.

2. Enforceability

(i) English law

One of the difficulties which a policyholder will encounter in enforcing a cut-through clause under English law is that in the usual insurance/reinsurance chain there is no contract between the policyholder and the reinsurer. The policyholder contracts with the insurer and, separately, the insurer with the reinsurer. Under English law rules relating to privity of contract, only the parties to a contract are bound by it or entitled to benefit under it. Thus, the policyholder can only seek to enforce the cut-through clause against the liquidator of the insolvent insurance company. For obvious reasons, the liquidator may not be willing to facilitate a scheme the purpose of which is to deprive the insolvent insurance company of funds. Similarly, the clause gives the reinsurer the power, but not the obligation, to pay the policyholder direct.

Various ways have been suggested in the past for overcoming these difficulties, for example concluding the agreement under seal between all the parties ie. the policyholder, the insurance company and the reinsurers, or by providing in the contract documents that the insurance company will hold any reinsurance policy proceeds in trust for the policyholder and not as part of the insolvent estate. Whilst these methods might overcome the problem of the absence of privity, they would still be open to attack by a liquidator on the grounds that they constitute a preference under Section 239 Insolvency Act 1986. This prohibits the giving of a preference which puts a creditor into a position which, in the event of the insolvency of the company giving the preference, is better than the position the creditor would have been in if that thing had not been done.

The House of Lords has held that attempts to "contract out" of this provision, even if entered into for good business reasons, are against public policy ***(British Eagle International Airlines Limited* -v- *Compagnie Nationale*** [1975] 1 WLR 758). Interestingly this judgment was given by a majority of 3:2.

(ii) US law

As a general rule there is no privity of contract between a policyholder and a

reinsurer. Only parties in privity with the reinsurer may seek direct recovery of reinsurance policy proceeds. However, nearly all US jurisdictions have confirmed the legality and enforceability of cut-through clauses. Parties may create privity directly between the policyholder and the reinsurer provided that the language used is explicit. This is notwithstanding that all US states now require the inclusion of insolvency clauses in reinsurance agreements most of which contain language stating that in the case of the insolvency of the ceding insurance company, the reinsurance proceeds must be paid directly to the liquidator. For example, the California insurance code Section 922.2 states:

> "In the event of insolvency and the appointment of a conservator, liquidator or statutory successor of the ceding company, such portion shall be payable to such conservator, liquidator or statutory successor immediately upon demand, ... without diminution because of such insolvency or because such conservator, liquidator or statutory successor has failed to pay all or a portion of any claims. Payments by the reinsurer as above set forth shall be made directly to the ceding insurer or to its conservator, liquidator or statutory successor, *except where the contract of insurance or reinsurance specifically provides another payee of such reinsurance in the event of the insolvency of the ceding insurer.* (Emphasis added).

The law of Florida provides:

> "All reinsurance proceeds payable under a contract of reinsurance to which the insolvent insurer is a party are to be paid directly to the domiciliary receiver as general assets of the receivership estate *unless the reinsurance contract contains a clause which specifically names the insolvent insurer's insured* (sic) *as a direct beneficiary of the reinsurance contract.* (Emphasis added).

The statutes of North Carolina and North Dakota are similar. In several other states, the legislators have attempted both to approve the enforceability of cut-through clauses and to set forth the conditions under which the reinsurer can pay the policyholder without risk of double liability. There are some states where the

prescribed insolvency clause language requires payment to the ceding company or its liquidator or other successor with no provision for an alternative payee, for example Michigan, in which case the enforceability of a cut-through clause must be in doubt.

(iv) Australian law

Section 562(A), Corporations Law which came into effect in 1992 provides that in the winding up of an insurance company, a person to whom the insurer was liable in respect of a claim has priority in relation to any reinsurance monies that are payable in respect of that liability. The relevant section is in the following terms:

562A(1) [Application of section] This section applies where:

(a) a company is insured, under a contract of reinsurance entered into before the relevant date, against liability to pay amounts in respect of a relevant contract of insurance or relevant contracts of insurance; and

(b) an amount in respect of that liability has been or is received by the company or the liquidator under the contract of reinsurance.

562A(2) [Amount received in reinsurance exceeds amounts payable by company]

Subject to subsection (4), if the amount received, after deducting expenses of or incidental to getting in that amount, equals or exceeds the total of all the amounts that are payable by the company under relevant contracts of insurance, the liquidator must, out of the amount received and in priority to all payments in respect of the debts mentioned in section 556, pay the amounts that are so payable under those contracts of insurance.

562A(3) [Calculation where sec 562A(2) does not apply]

Subject to subsection (4), if subsection (2) does not apply, the liquidator must, out of the amount received and in priority to all payments in respect of the debts

mentioned in section 556, pay to each person to whom an amount is payable by the company under a relevant contract of insurance an amount calculated in accordance with the formula.

$$\frac{\text{Particular amount owed}}{\text{Total amount owed}} \times \text{Reinsurance payment}$$

where:

"Particular amount owed" means the amount payable to the person under the relevant contract of insurance;

"Total amount owed" means the total of all the amounts payable by the company under relevant contracts of insurance;

"Reinsurance payment" means the amount received under the contract of reinsurance, less any expenses of or incidental to getting in that amount.

562A(4) [Court may order payment of different amount]

The Court may, on application by a person to whom an amount is payable under a relevant contract of insurance, make an order to the effect that subsections (2) and (3) do not apply to the amount received under the contract of reinsurance and that that amount must, instead, be applied by the liquidator in the manner specified in the order, being a manner that the Court considers just and equitable in the circumstances.

3. Recent English case law

Whether or not the express words of insurance and reinsurance contracts confer on the policyholder a direct right of action against the reinsurer, the reinsurer may be willing to accept liability for payment of claims direct to a policyholder if the policyholder agrees that it will not make any claim against the insolvent insurance company. From the reinsurer's point of view it pays the same sum of money, and the policyholder gets paid in full. This might be appropriate where

there is a strong commercial relationship between the two. This arrangement would only be attractive if the reinsurer could be confident that it would not be required to pay twice (ie. to the policyholder, and also to the insurance company or its liquidator under the reinsurance contract).

This type of arrangement recently came before the English Courts in ***McMahon & Smith -v- AGF Holdings (UK) Limited [1997]***. In this case the liquidator argued not only that the arrangement was a preference in breach of the Insolvency Act 1986 but also that it was a breach of the contract of reinsurance or a wrongful interference with that contract. The Court took the second question as a preliminary issue. It assumed that there had in fact been a breach of contract or wrongful interference; the real issue was whether or not it followed from this that the insolvent insurer had suffered any loss for which damages would be the remedy.

The facts of the case were not straightforward. The National Employers Mutual General Insurance Association Limited (NEMGIA) became on an asset basis insolvent. It sold its business to AGF, which acquired it through a company which became known as NEMIC. In consideration of a large payment of premium, NEMIC also entered into a reinsurance contract, under which it reinsured a large part of NEMGIA's business.

One of the assets which NEMIC acquired was the goodwill of NEMGIA's policyholders. To ensure that these policyholders continued to receive payment in full of their claims, arrangements were put in place to enable NEMIC to negotiate and agree claims direct with the policyholders, and when monies were due to the policyholders, NEMIC on behalf of NEMGIA paid the policyholders direct.

This arrangement would, however, not survive the liquidation of NEMGIA. Where claims were made by policyholders and accepted by NEMGIA, the liquidator could (and in all likelihood would) require NEMIC to pay in full all sums due under the reinsurance agreements only to NEMGIA, and these monies would fall into a pool of assets available to the whole body of creditors. If this course was followed, the likelihood of renewals by these policyholders with

NEMIC would be adversely affected.

As a result, NEMIC put in place an arrangement under which NEMIC, not on behalf of NEMGIA but on its own behalf, would pay direct the policyholders in respect of all claims which were actually made, or which otherwise would be made, against NEMGIA, taking in return from the policyholders an assignment of their claims against NEMGIA.

By so doing, NEMIC would prevent NEMGIA having claims made against it or (if claims were made) from suffering a loss. NEMGIA would therefore be prevented from making any claim on NEMIC: it would have no occasion to do so. NEMIC in this way would be able to pay promptly and in full all policyholder claims as was necessary to preserve its goodwill, but would not be obliged to make any payment under reinsurance contracts to NEMGIA.

NEMGIA, by its liquidator, complained that the policyholders were wrongly prevented from making any claims against NEMGIA. If such claims had been made, NEMGIA would have been entitled to obtain recoveries from NEMIC equal in amount to the claims to be met.

The Judge (Lightman J) held that, as a matter of commonsense under the law of damages, the liability to policyholders and the right to indemnity from NEMIC were two sides of the same coin and must be netted off one against the other. In these circumstances, he failed to see how the loss of this package could possibly have occasioned NEMGIA any substantial damage.

The critical issue in this case was the effect of the arrangement on the assets and liabilities of the insolvent insurance company. The consequences of this were held to be neutral. This left open the equally important question of whether the answer would be different when the issue was the effect on the general body of creditors ie. was the arrangement a preference? This is the focus of the Insolvency Act. On the face of it, it would seem that creditors would be disadvantaged as a result of some policyholders receiving payment of their claims in full direct from the reinsurers because this would reduce the assets of the insolvent insurance company available for distribution amongst the general

creditors. Unfortunately we will not know the answer to this question in the context of this case because the litigation has been settled on terms which we understand involved a modest payment by AGF to the liquidator.

Conclusion

The future for the enforceability of cut-through clauses under English law probably lies with Parliament. Certainly it is the legislatures in the United States and Australia that have taken the lead in those jurisdictions. In 1930 Parliament passed the Third Parties (Rights Against Insurers) Act which transferred the rights of the assured against the insurer to the third party who had been injured by the assured. The condition triggering that transfer was the insolvency of the assured. Whilst the policy considerations are different, the concept is the same.

In July 1996 the Law Commission reported to Parliament on "Privity of Contract: Contracts for the Benefit of Third Parties" and recommended that the rule of English law whereby a third party to a contract may not enforce it should be reformed so as to enable contracting parties to confer a right to enforce the contract on a third party. It remains to be seen whether or not the Law Commission's recommendations will be accepted by Parliament. If they are not accepted, the Courts could take matters into their own hands. In ***Beswick -v- Beswick*** [1968] AC p58, Lord Reid referred to a strong Law Revision Committee Report in 1937 which recommended:

> "That where a contract by its express terms purports to confer a benefit directly on a third party it shall be enforceable by the third party in his own name ...."

Lord Reid continued:

> "And, if one had to contemplate a further long period of Parliamentary procrastination, this House might find it necessary to deal with this matter. But if legislation is probable at an early date I would not deal with it in a case where that is not essential".

Almost 30 years later the issue is still burning.

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Are the Judiciary Re-writing Insurance Policies ?

by Derrick Cole

Recent Court decisions have suggested that what insurers state in their policies do not always mean what they intended they should. Disablement from 'any occupation' would not appear to mean 'any relevant occupation'. (***Court of Appeal - Sargent v. Gre(UK) Ltd.***Times Report 25/4/97), where a claim is made under a personal accident or sickness insurance for permanent total disablement. If you have injured your hand and can no longer continue your occupation as a carpenter and cannot therefore engage in any occupation where the use of your hand is essential, you are now likely to obtain benefit where the cover is restricted to 'any occupation' as compared to where the words 'your existing occupation' are used, when the cover would have been automatic. However, any sensible broker would arrange cover on the wider wording as it is highly unlikely that an insured would be prevented from engaging in any occupation unless the injury or illness caused blindness or paralysis.

'Increase in Risk' clauses are quite common in material damage policies and require the insured, during the currency of the policy, to advise the insurer of "any alteration in the risk which was likely to increase the risk". In the case of ***Hussein v. Brown [1996]*** 1 Lloyd's Rep 627, the Court held that breach of contract by the insured in failing to advise the insurer that the factory was unoccupied, resulted in the risk of fire being increased as there was a fifty/fifty chance that the fire would not have occurred had the insurers had the opportunity to apply protective warranties, such as requiring the insured to board up the windows on the ground floor. This now suggests that the Courts have the right to make proportionality type awards and the insurers' liability was reduced accordingly by the Court.

In the case of ***Kauser v. Eagle Star*** (1996) Times 15/7/96, the insured had a duty under the terms of the policy to advise the insurer of "change of circumstances after the start of the insurance which increases the risk of injury or damage." The Court held that mere increase in risk does not fall within the words of a standard

notification clause, so that unless the risk is changed, as opposed to merely increased, the insurer is not off risk. In this case there had been a broken window and the tenant of the shop premises threatened to breach the lease by sub-letting the property and also threatened to damage the property. The insurer now appears to be liable for all insured losses, the causes of which are reasonably foreseeable. It is therefore reasonable, I would suggest, that if the central heating breaks down, an insured might install a gas fired portable heating apparatus as a temporary measure without having to tell the insurer, even though they are in themselves quite dangerous from a fire point of view, quite apart from the storage of spare cylinders on the premises. However, if the whole nature of the risk changes and the insured alters the business from say, making metal parts to plastic ones, this is another matter and must be advised to insurers. This further demonstrates that words in insurance contracts do not always mean what they were intended they should mean and it makes the task of the broker that much more difficult to point out to the insured, as is his/her duty, the meaning of conditions and warranties which, are, to say the least, uncertain.

If the above mentioned cases are not enough to create problems for underwriters and brokers alike, only last month in ***Economides v. Commercial Union Assurance Co. PLC*** (Times 27/6/97), we discovered, again in the Court of Appeal, that when insuring household contents, if the insured gets the value completely wrong, providing the value was honestly believed and not deliberately under-estimated, the insurer cannot plead misrepresentation. This appears to be an extraordinary decision, bearing in mind the sum insured was £16,000 compared with the true value of £40,000 and one wonders if their Lordships were aware of a possible knock-on effect of this decision. It means that in the absence of deliberate underinsurance the insured is entitled to a first loss insurance. The insurer is therefore not obtaining a premium commensurate with the risk and we shall expect more (non-Lloyd's) policies to incorporate an average clause. Quite a number of insurers are issuing policies with fixed sums insured of £30,000 or £35,000 without the need for the insured to look too closely at the actual value providing it does not exceed those figures and maybe we shall see more of this kind of contract which are generally rated on the number of bedrooms.

In just one final case in July this year (***T A Chapman Ltd and Benson Turner***

Limited v. Paul George Christopher and Sun Alliance and London Insurance Plc), an insurer under a liability policy who thought the limit of their liability was £1 million including costs, found that because they had unsuccessfully defended an action where the original award was £1.2 million plus costs, the Court of Appeal held the insurer liable for the Plaintiffs costs where an order was sought under section 51 of the Supreme Court Act. Before this case, I have no doubt the insurers had allowed for a maximum loss of the limit under the policy. The insurers are considering an appeal to the House of Lords so perhaps this is not the final precedent.

Where does that leave us ? I am afraid very much in the world of uncertainty where insurers will have to look even more carefully at their wordings and brokers are left with the difficult task of interpreting wordings to their clients. Further, the more unreasonable the clause, the more likely are the Courts to find against the insurers and any evidence of breach has to be conclusive. I have always followed the maxim that if in doubt, tell the insurer of any changes in your business, thus avoiding any possible comeback in the event of loss.

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