Thai flood reinsurance dispute: meaning of follow settlements clause - Commercial Court decision 6 November 2013

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By Jane Beacham, Partner

In the case of *Tokio Marine Europe Insurance Limited v Novae Corporate Underwriting Ltd* in which judgment was handed down on 6 November 2013, Mr Justice Hamblen decided three points of general interest to reinsurers. He gave full effect to a follow settlements clause that requires a retrocessionaire to follow the original insurer's settlements. In reinsurance contracts which are on the same terms as the original and contain unqualified follow settlements clauses, he decided (albeit with reluctance) that the reinsured need only prove that its claim is arguably covered by the reinsurance in order to recover. He also decided that in such contracts the reinsurer was bound by the reinsured's determinations on questions of construction of the original policy.

Clausen Miller LLP acted for Tokio Marine Europe Insurance Limited (TMEI) and instructed **Stephen Midwinter** of Brick Court Chambers.

The Established Law

As Lord Mustill stated in *Hill v Mercantile and General Reinsurance Co Plc* [1996] 1 WLR 1239, there are only 2 rules in considering the meaning and effect of follow settlements clauses: "*First, that the reinsurer cannot be held liable unless the loss falls within the cover of the policy reinsured and within the cover created by the reinsurance. Second that the parties are free to agree on ways of proving whether these requirements are satisfied."* There are a number of leading authorities which illustrate the agreements that parties have put in place over the years.

The type of follow settlements clause considered in *Hill v Mercantile* was qualified or "*double proviso*" in that the reinsured agreed to follow the settlements of the insured "*providing such settlements are within the terms of the conditions of the original policies and/or contracts…and within the terms of this reinsurance".* Therefore, the reinsured must therefore prove that the claim is in fact covered by the insurance and the reinsurance.

Mr Justice Hamblen's judgment concerns a retrocession containing an unqualified or single proviso follow settlements clause. The effect of such a clause was authoritatively considered by the Court of Appeal in *Insurance Company of Africa v Scor (UK) Reinsurance Co Ltd* [1985] 1 Lloyd's Rep 312 and described by Lord Justice Goff as follows:

"In my judgment, the effect of a clause binding reinsurers to follow settlements of the insurers, is that the reinsurers agree to indemnify insurers in the event that they settle a claim by their assured, i.e., when they dispose, or bind themselves to dispose, of a claim, whether by reason of admission or compromise, provided that [1] *the claim so recognised by them falls within the risks covered by the policy of reinsurance as a matter of law* [the first proviso]*, and* [2] *provided also that in settling the claim the insurers have acted honestly and have taken all proper and businesslike steps in making the settlement* [the second proviso]."

The Facts

The dispute arose out of the Thai flood in autumn 2011. Over 165 Tesco properties were affected. Tesco claimed material damage and business interruption losses under a global master policy and a local policy both issued by ACE. The claim was adjusted and settled in

early 2012 on the basis that the damage arose from one occurrence so that one deductible and one captive retention applied.

ACE was facultatively reinsured by various reinsurers including TMEI (the Reinsurance). TMEI in turn placed facultative excess of loss reinsurance with Novae in respect of its losses (the Retrocession).

TMEI agreed and paid its share of the settlement and then sought to recover under its excess of loss protection. Novae refused to pay. One of its arguments was that under the terms of the master policy there were multiple occurrences so that multiple deductibles applied.

TMEI brought proceedings against Novae in the Commercial Court. The Retrocession contained an unqualified follow settlements clause.

The Preliminary Issues

The following 5 issues arose for determination as preliminary issues in the litigation:

1 Does the Retrocession reinsure TMEI for its liability to ACE in respect of the local policies?

2 Is the term "*Loss Occurrence"* in the Retrocession to be construed in the same manner as *"Occurrence*" in the Master Policy?

3 Did Novae agree under the Retrocession to follow the settlements of ACE or of TMEI?

4 To what standard of proof does TMEI have to show that the claim so recognised by ACE falls within the Retrocession as a matter of law – balance of probabilities or arguability?

5 Is Novae bound by a determination by ACE (if any) as to the construction and application of the aggregation provisions in the Master Policy to the Tesco losses?

The Judge found in TMEI's favour on all 5 issues but made clear that in relation to issue 4 he was bound by an earlier decision of the Court of Appeal although he disagreed with the reasoning in that decision. This note is confined to an overview of issues 3, 4 and 5 which will be of general interest to reinsurers and which are referred to below as A, B and C.

A Did Novae agree under the Retrocession to follow the settlements of ACE or of TMEI?

The relevant clause in the Retrocession provided as follows (emphasis added):

Reinsurance Conditions	*Following Original Policy Wording Reference Number: UKFRIC38309.10.*
	This Contract is subject in all respects … to the same terms, clauses and conditions as original and without prejudice to the generality of the foregoing, Reinsurers agree to follow all settlements (excluding without prejudice and ex-gratia payments) made by original Insurers arising out of and in connection with the original insurance …"

TMEI argued that it was plain that the settlement referred to in the follow settlements clause above was the settlement made by ACE who were "*original Insurers*" under the Master policy. Novae had admitted that other references to *"original"* elsewhere in the slip were references to ACE. The Judge agreed that this was the natural meaning of the words used when considered in their textual context and rejected Novae's submission that this was simply sloppy drafting.

The Judge accepted that follow settlements clauses often oblige the reinsurer to follow the settlements of the immediate reinsured and that there may be good reasons for preferring to follow the settlements of a counterparty rather than of a third party. However, this does not override "*the clear and unambiguous meaning of the words used in the Retrocession contract*". The Judge further considered that "*there are good commercial reasons why in this case the 'settlement' that Novae must follow, and in relation to which it is entitled to information, is the original settlement between the ACE insurers and Tesco. That is the "coalface" and the level at which the substance of the claim will have been thrashed out and coverage issues determined.*" He concluded that Novae had agreed to follow the settlements of ACE.

B To what standard of proof does TMEI have to show that the claim so recognised by ACE falls within the Retrocession as a matter of law – balance of probabilities or arguability?

This issue concerned the interpretation and application of first proviso set out by Lord Justice Goff in *Scor,* that is, what is meant by *"the claim so recognised by them falls within the risks covered by the policy of reinsurance as a matter of law"?* The Judge considered in detail the judgments in two cases which have addressed this question, the key passages of which are set out below: Evans J in *Hiscox v Outhwaite (No.3)* [1991] 2 Lloyd's Rep 524 and by the judge at first instance and by the Court of Appeal in *Assicurazioni Generali Spa v CGU International Insurance plc* [2003] 2 All ER (Comm) 425 (Mr Kealey QC); [2004] Lloyd's Rep IR 457 (Court of Appeal) and following case law.

In *Hiscox*, the reinsured sought to recover from reinsurers in respect of sums paid under the Wellington Settlement in relation to asbestos liabilities. It was common ground that the sums paid under the Wellington Settlement were not calculated by reference to the reinsured's actual liabilities for specific claims but rather by reference to its market share, and that as a result it was inevitable that the sums paid by the reinsured included sums paid in respect of claims that were not covered by the insurance or the reinsurance. The reinsured sought to contend that the reinsurer was nevertheless bound to follow its settlement. Evans J held that it was not, because the claims were not even arguably covered by the insurance or reinsurance as a matter of law:

"*In my judgment, the reinsurer is always entitled to raise issues as to the scope of the reinsurance contract, and where the risks are co-extensive with those of the underlying insurance he is not precluded from raising such issues, even when there is a "follow the settlement" term of the reinsurance contract. Ultimately, this is the only sure protection which the reinsurer has against being called upon to indemnify the reinsured against payments which were not legally due from him to the original insured, however reasonable and businesslike the payments may have been. But this is subject to* ***one proviso*** *which I have already assumed in the Syndicate's favour … The reinsurer may well be bound to follow the insurer's settlement of a claim which arguably, as a matter of law, is within the scope of the original insurance, regardless of whether the Court might hold, if the issue was fully argued before it, that as a matter of law the claim would have failed."*

The judgment of Evans J and how the first *Scor* proviso works in practice was considered by Mr Gavin Kealey QC sitting as Deputy High Court Judge in *Generali*.

Mr Kealey QC noted a "*significant*" distinction between having to prove (1) that a loss falls within the cover of both the insurance and reinsurance and, (2) that a claim so recognised as falling within cover of the insurance also falls within cover of the reinsurance. For (1) "*one is examining what in fact happened*"; for (2) "*one is examining the real basis on which a claim has been settled"* and in so doing *"one is looking to identify the factual and legal ingredients of the claim"*.

When considering how to identify the factual and legal ingredients and so the circumstances in which a reinsurer may be bound, Mr Kealey QC referred to the finding of Evans J in Hiscox. He noted and agreed with the view of Evans J that in a case where the risks reinsured are co-extensive with the original insurance, the effect of a follow settlements clause may be to bind the reinsurers to a compromise as to liability, including coverage under the terms of the insurance, as a matter of law. This is provided that the insurers have acted honestly and taken all proper and businesslike steps. Mr Kealey QC agreed with the conclusion of Evans J that: in these circumstances, "*reinsurers 'may well be bound' to follow the insurers' settlements and, implicitly therefore, may well be precluded from raising under the contract of reinsurance the same issues in relation to liability and scope of cover as had already been disputed and compromised, or admitted, by settlement under the contract of insurance."*

Mr Kealey QC identified 3 reasons for agreeing with Evans J in circumstances where the parties have agreed that the insurance and reinsurance are to have identical terms and equivalent scope of cover:

1 If reinsurers were allowed to reopen the same issues of coverage under the reinsurance, the result in practical and legal terms would be akin to the parties having agreed to a qualified or double proviso follow settlements clause.

2 Where reinsurers have trusted insurers to determine whether risks are covered by the insurance as a matter of law, it would be inconsistent for the reinsurers to then dispute those same questions of law. Where there is a combination of back to back cover and a promise to follow the insurers' settlements and the insurers have taken all proper and businesslike steps to compromise a dispute the reinsurers should be bound to follow that settlement;

3 The follow settlements promise binds reinsurers to a proper and businesslike compromise or admission of liability by insurers. For the insurers to then have to prove to reinsurers that on the settled facts they were legally liable to the insured – which would be the inevitable outcome were reinsurers entitled to require insurers to show that the settled facts fell within the risks reinsured – would replace the unqualified follow settlements clause with something very different.

Mr Kealey QC concluded that:

> *"The defendants are bound by all settlements made by Generali (except ex-gratia and without prejudice settlements) (a) provided that the claims so recognised by Generali fall within the risks covered by the contract of reinsurance as a matter of law: by which is meant in this context as explained above, provided that the claims were settled on a basis which, if and assuming it to be valid, falls within the risks covered by Generali's outward contract of reinsurance as a matter of law; and (b) provided that Generali acted honestly and took all proper and businesslike steps in making such settlements."*

The Court of Appeal upheld Mr Kealey QC's decision in far shorter terms as set out by Lord Justice Tuckey:

> "17 *The proviso to which Evans J refers is that reinsurers are bound by reasonable compromises on liability and quantum between the insurers and their assured under the terms of the original policy. That, as I have already said, is well established: the insurer does not have to prove that if the original claim was fully argued it would in fact have succeeded. No investigation as to whether it was arguably within the terms of the original policy is required. But what Evans J says about the reinsurance is clear. Like the judge, I agree with what he says.*
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> *18 What I have said so far disposes of Mr Hofmeyr's submissions on this part of the case which I do not accept. But none of the earlier cases have considered how the first proviso works in practice in a case such as this. Here the judge has done so. By reference to the words 'the claim so recognised' he has concluded that the insurers do not have to show that the claim they have settled in fact fell within the risks covered by the reinsurance, but that the claim which they recognised did or arguably did. I think this gives effect to what Robert Goff LJ said and gives some sensible added meaning to the clause. It gives substance to the fact that the reinsurer cannot require the insurer to prove that the assured's claim was in fact covered by the original policy, but requires him to show that the basis on which he settled it was one which fell within the terms of the reinsurance as a matter of law or arguably did so. This and the need for the insurer to have acted honestly and taken all reasonable and proper steps in settling the claim provide adequate protection for the reinsurer"* (emphasis added).

TMEI argued that Tuckey LJ is stating that the correct standard of proof or test to be applied is whether the basis on which the claim is settled arguably falls within the terms of the reinsurance.

However, Novae submitted that Evans J in *Hiscox*, with whose proviso the Court of Appeal agreed, was in fact saying that where a claim arguably falls within the inward (re)insurance contract and is compromised on that basis, that settlement might bind the reinsurer where the terms of insurance and reinsurance are identical. Neither Evan J nor Mr Kealey QC was saying that the standard of proof to be applied in showing that the settlement or "*claim so recognised*" falls within the outward contract of reinsurance is merely "*arguability*" as opposed to balance of probabilities. This would be contrary to the reinsurer's right as recognised by Evans J to say that the settlement falls outside the reinsurance.

Novae submitted, that Tuckey LJ was upholding the judgments of Evans J and Mr Kealey QC and confirming that the threshold is arguability, but arguability under the inward rather than the outward contract.

Mr Justice Hamblen considered "*There is considerable force in Novae's submissions"* and agreed with Novae's analysis of the judgments of Evans J and Mr Kealey QC. He also agreed in principle that "*it is difficult to see why a lesser standard of proof than the usual civil standard should govern the application of the first Scor proviso to the reinsurance*".

However, the Judge did not agree that Tuckey LJ was simply upholding the judgments of Evans J and Mr Kealey QC. He considered that paragraph 18 of the Court of Appeal's judgment in *Generali* is the *ratio* of that case and that Tuckey LJ held that the test of arguability relates to the reinsurance. The reinsurer cannot require the insurer to prove that the insured's claim was in fact covered by the original policy, but only to show that the basis

on which the claim was settled was one which fell within the terms of the reinsurance as a matter of law or arguably did so.

On this point the Judge held that he was bound by the Court of Appeal's decision although he disagreed with the reasoning in that decision.

C Is Novae bound by a determination by ACE (if any) as to the construction and application of the aggregation provisions in the Master Policy to the Tesco losses?

This issue required consideration of when the *Scor* proviso is to be applied in the manner set out in *Generali*.

It was assumed that ACE's settlement included the compromise of an underlying construction argument which Novae wished to reopen namely the relationship between the definition of "Occurrence" and separate 72 hours clause in the original policy wording.

Novae sought to argue that the definition of Occurrence – "*any one Occurrence or series of Occurences consequent upon or attributable to one source or original cause*" – should be displaced by the 72 hour clause. Therefore, that each group of losses occurring within a period of 72 hours was a separate "*Occurrence*". However, ACE compromised the underlying claim on the basis that the Thai flood was attributable to one source or original cause and so constituted a single Occurrence with one deductible applying.

TMEI argued that it was at least arguable that the 72 hours clause did not displace the definition of Occurrence and that the correct construction of the aggregation provisions is that (a) where losses fall within the 72 Hours clause then that clause operates so as to bring all losses within a consecutive 72-hour period into a single Occurrence but (b) where losses occurring over a period greater than 72 hours all arise out of a single source or original cause then the effect of the definition of Occurrence is to aggregate them all into a single Occurrence.

Novae argued that this case is distinguished from *Generali* because:

i) the Retrocession was a non-proportional excess of loss contract of reinsurance;

ii) the Retrocession was not back-to-back with the Reinsurance; and

iii) the Retrocession was concerned with the reinsurance of another reinsurer.

The Judge rejected each of Novae's points as follows:

i) The Judge accepted that the Retrocession was a non-proportional excess of loss contract so that the parties' interests will not always be the same. However, in many cases their interests were likely to be similar. For example, in relation to aggregation issue it was in the interests of the insurer/reinsurer under each contract (ACE/TMEI and TMEI/Novae) for there to be a number of Occurrences.

ii) Given the Judge's findings in relation to preliminary issues 1 and 2 there was no material difference between the terms of the Reinsurance and Retrocession and so the Judge found that in that sense they were back-to-back.

iii) Novae argued that it was one removed from the direct insurance provided by ACE and was therefore in a similar position to the "*remote reinsurer*" in the *Hill v Mercantile* case "*who may know nothing beyond the identity of his reinsured and the terms of his own cover*". The Judge rejected this submission. The Reinsurer in *Hill v*

Mercantile was at the end of a long chain of reinsurances in an LMX spiral. In this case, Novae was only one removed from ACE and had in fact itself reinsured ACE the previous year.

The Judge did not therefore accept that the factual distinctions drawn were as significant as Novae contended. In any event, he did not regard them as sufficient in principle to displace the meaning given to the materially same unqualified follow settlements clause in *Generali.*

He held that:

> *"Where the relevant terms are materially identical one can well understand why reinsurers should be bound by the legal basis of the settlement, provided it arguably falls within the reinsurance. If it were otherwise the reinsurer, having agreed an unqualified follow settlements clause, would be entitled to attempt to avoid paying its share of a settled claim by re-litigating an issue of construction arising on a materially identical clause, which has been the subject of dispute between the original insured and the original insurer, resulting in a compromise that accepted the insured's argument as correct and which cannot be criticised as unreasonable. If, as is accepted, the unqualified follow settlements clause prevents this in relation to issues of fact, it is difficult to see why that should not equally apply where the issue that has been settled is one of construction of a materially identical clause."*

The Judge noted that the 3 reasons identified by Mr Kealey QC in *Generali* as to why the reinsurer should generally be bound by an unqualified follow settlements clause were apposite in this case. The terms governing coverage and aggregation clauses were materially identical in the Reinsurance and Retrocession.

The Judge considered that Novae's argument was in effect that the unqualified *Scor* type follow settlements clause in the Retrocession should be construed in the same way as a qualified or double proviso *Hill v Mercantile* type follow settlement clause. The effect of an unqualified follow settlements clause has been clear at least since *Generali* was decided. Had Novae "*wished to make it possible for reinsurers to dispute that the settlement was not within the legal extent of the cover provided, there is a well established means of so doing – namely, the qualified Hill v Mercantile type follow settlements clause. That course was not taken. Instead an unqualified follow settlements clause was used*."

The Judge quoted Lord Hobhouse noted in *Lloyds TSB General Insurance Holdings & Ors v Lloyds Bank Group Insurance Co Ltd.* [2003] Lloyd's Rep IR 623 at [31]:

> "*Another preliminary observation which needs to be made, which is true of very many professionally drafted commercial and financial contracts, and is particularly true in the present case, is that there are often well established alternatives open to the parties in the drafting of their agreement. The choice made from among these alternatives represents part of the bargain struck by the parties and must be respected by anyone (judge or arbitrator) adjudicating upon a dispute arising under the document. As noted by Lord Mustill in Axa Re v Field [1996] CLC 1169 at pp. 1173-7; [1996] 1 WLR 1026 at pp. 1031-5, and, as I will explain below, aggregation clauses come in different well established forms. The clause in the present case is no exception*."

The Judge stated that "*The same observation can be made in respect of follow settlements clauses and the choice made in this case*".

Comment

The Judge gave a clear indication that in his view clarification is required about the standard of proof to be applied in relation to unqualified follow settlements clauses of the type considered in this case.

However, the Judge was in no doubt that he wished to give full effect to the follow settlements clause which required the retrocessionaire, Novae, to follow the settlements of the original insurer, ACE. Further, that in reinsurance contracts which are on the same terms as the original and contain unqualified follow settlements clauses, he was clear that the reinsurer is bound by the reinsured's determinations on questions of construction of the original policy.