MILLS & REEVE

REINSURANCE BRIEF CASES

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Claims handling costs should not be given priority over other debts of an insolvent company – CENTRE REINSURANCE INTERNATIONAL CO AND OTHERS v FREAKLEY AND OTHERS, House of Lords, 11 October 2006

Several tort claims were made against T & N Limited ("**the Insured**") arising out of its use of asbestos. As a consequence it became unlikely to be able to pay its debts. Administrators were appointed for the purposes of approving a scheme of arrangement under section 425 of the Companies Act 1985.

The Insured held an asbestos liability policy under which insurers agreed to indemnify the company against its ultimate net loss (which was defined to include both established liabilities under the asbestos claims and the costs of defending and handling those claims) up to a limit of £500 million. It was a condition of the insurance policy that after the occurrence of an insolvency event insurers should have the exclusive right to handle and defend claims. The loss was wholly reinsured. In a related decision in February 2005, the Court of Appeal held that claims handling rights were transferred to Reinsurers at the time of the administration order.

Based on existing case law, it was accepted that in handling claims (re)insurers act as agents for the company and are entitled to reimbursement for their expenses. The question in this case was whether the right to reimbursement for any such costs incurred after the appointment of an administrator had statutory priority over other costs of the administration, the floating charge and the company's unsecured creditors.

The basis for such an argument was section 19(5) of the Insolvency Act 1986 which gives priority to any debts or liabilities incurred under contracts entered by an administrator in carrying out his functions. Reinsurers argued that section 19(5) applied to claims handling expenses incurred after the appointment of the administrator, since a company in administration could only act via its administrator. Accordingly, any liabilities incurred on behalf of a company in administration must have been incurred on behalf of the administrator.

The Court of Appeal had accepted Reinsurer's arguments, ie, that claims handling expenses amounted to liabilities incurred by the administrator in carrying out his functions under section 19(5). The House of Lords disagreed. Whilst it is true that once an administrator has been appointed only he can act or confer authority to act on behalf of the company, that does not mean that anyone with authority to act on behalf of the company must be deemed to have derived authority from the administrator. Before the appointment of the administrator the company may have conferred authority to contract on its behalf, which in law or in practice the administrator cannot revoke. This was such a case. The claims handling costs had been incurred by the company and not the administrator.

Further, the House of Lords could see no reason of policy why claims handling expenses should be given priority over the company's other debts.

The court in exercising its supervisory powers over an administration has a broad discretion to authorise or direct an administrator to make payments or enter into contracts for the purposes of the administration. This could include that certain claims handling expenditures incurred by (re)insurers have priority. The House of Lords considered that it would be unusual for a court to make such a decision, as (re)insurers want to handle claims to protect their own interests, which has little to do with the purposes of the administration. In any event, there was insufficient evidence of the particular claims handling costs in this case to assess whether it would be appropriate to exercise this discretion. The House of Lords upheld the first instance decision of Mr Justice Blackburne who had refused to make a blanket order authorising the payment of the claims handling expenditure.

Comment

Clearly the House of Lords decision that claims handling costs incurred by (re)insurers will not constitute a cost of the administration, so will not be given priority over an insolvent company's other debts, is not one which will be welcomed by (re)insurers. It appears that in future (re)insurers will generally only be able to obtain reimbursement for claims handling expenses incurred after an insolvency event, if there is money available to pay some or all of the ordinary unsecured liabilities or, if appropriate, by exercising a right of set off against any liability of (re)insurers to indemnify the (re)insured in respect of the claims being handled.

Courts' jurisdiction to hear appeals – CGU INTERNATIONAL INSURANCE PLC & OTHERS v ASTRA ZENECA INSURANCE CO LTD, Court of Appeal, 16 October 2006

Astra Zeneca Insurance Co Limited ("**Astra Zeneca**"), the captive insurer of Astra Zeneca plc, insured the group's global property and liability risks (the "**Insurance Contract**"). CGU International Insurance plc reinsured Astra Zeneca's liability in respect of personal injuries and property damage (the "**Reinsurance Contract**"). The Reinsurance Contract was expressly subject to English law and jurisdiction. The Insurance Contract contained no express choice of law, but it was seemingly accepted by the parties that English law governed it. It also contained a "*USA Service of Suit*" clause which bound insureds operating within the USA to submit to a court of competent jurisdiction within the USA. The Reinsurance Contract contained a London arbitration clause.

The underlying dispute arose when one of the Astra Zeneca plc group companies operating in Iowa allegedly breached the terms of its licence solely to produce and distribute genetically modified corn-seed for animal feed purposes when some of the genetically modified corn-seed was detected in human foodstuffs. A number of claims were brought by farmers, food manufacturers and food processors. The claims (totalling US$2 billion) were eventually settled for approximately US$80 million. Astra Zeneca paid the claims and sought recovery under the Reinsurance Contract. The Reinsurers declined liability for approximately 90% of the claim on the basis that the losses did not arise out of property damage. Astra Zeneca argued that had it declined liability under the Insurance Contract, proceedings would have been commenced against it in the Iowa courts and those courts, applying Iowa law to the Insurance Contract (in accordance with their local conflict of laws rules), would have held that all amounts claimed under the Insurance Contract were covered as damages on account of property damage.

The dispute went to arbitration in London. The panel consisted of a New York lawyer, a London underwriter, and Kenneth Rokison QC as chairman. The panel was split on the question of the proper law that should be applied to the claim, with the New York lawyer and the London underwriter holding that the proper law for the claim was Iowa law and Mr Rokison holding that it was English law. The arbitration panel made an award in favour of Astra Zeneca.

The Reinsurers appealed the award of the arbitrators to the Commercial Court on the grounds that there had been serious irregularity in the panel's findings and contended (amongst other things) that the panel had ignored Astra Zeneca's acceptance that English law was the proper law of the Insurance Contract. As a preliminary question, the Commercial Court judge (Mr Justice Cresswell) was asked to determine the proper law of the Insurance Contract and the Reinsurance Contract. He agreed with Mr Rokison's analysis and allowed the appeal in favour of the Reinsurers, which meant that English law applied to the claim. Astra Zeneca was refused permission to appeal by the judge and it applied directly to the Court of Appeal.

Section 69(8) of the Arbitration Act 1996 prohibits an appeal to the Court of Appeal where the lower court has refused to give permission for the appeal. Astra Zeneca argued that this was incompatible with the requirement for fairness under Article 6 of the European Convention for the Protection of Human Rights and Fundamental Freedoms (the "**Human Rights Convention**"), now incorporated into English law by the Human Rights Act 1998.

The Court of Appeal held that despite the provisions of the Arbitration Act 1996, the court retained a residual jurisdiction to enquire into any unfairness in the process of a refusal of leave. The Court of Appeal held that the higher court was not interested in the merits of the parties' dispute, nor the correctness of the judge's reasons, but only in the adequacy of the judge's reasons for refusing permission to appeal. The residual jurisdiction arises out of the need to maintain confidence in the administration of justice.

The court noted that the reasons given by Mr Justice Cresswell for not allowing Astra Zeneca permission to appeal to the Court of Appeal indicated that his refusal was not:

- arbitrary, unfair or perverse; or
- the product of a failure of intellectual engagement with the arguments before him; or

- indicative of an absence of a decision on the part of the judge, ie, the decision however flawed by error was arrived at by an intellectual process and not undermined through bias or personal interest; or
- unfair in process so as to amount to a breach of Article 6 of the Human Rights Convention (the Court of Appeal described this factor as the ultimate test).

The fact that the courts retain a residual discretion to consider an appeal based on the unfairness in the decision process meant that the Human Rights Convention had not been infringed.

Comment

The facts of the underlying dispute (which was heard in arbitration and before Mr Justice Cresswell in the Commercial Court) are undoubtedly of more interest to reinsurers and their brokers than the rather technical basis of this decision. However, reinsurers should note that the residual right to appeal an unfair decision is unlikely to be successfully established in most cases in practice. While setting out its decision in *CGU v Astra Zeneca*, the Court of Appeal made it clear that a wrongful refusal to grant permission to appeal a decision would not be subject to appeal in a higher court – no matter how flawed the decision – provided that the process followed by the judge when reaching his decision was not unfair. The Court of Appeal also indicated that it would be reluctant to hear most such appeals, since the purpose behind the legislation preventing appeal once leave is denied is designed to prevent issues being repeatedly brought before the courts by an unsuccessful party.

The interpretation of claims cooperation clauses – AIG EUROPE (IRELAND) LTD v FARADAY CAPITAL LTD (ON ITS OWN BEHALF AND ON BEHALF OF THE UNDERWRITING MEMBERS OF LLOYD'S SYNDICATE 435 FOR THE YEAR 2002), Queen's Bench Division, 31 October 2006

AIG provided directors and officers cover ("**the D&O Policy**") to Smartforce which was listed on the NASDAQ exchange. AIG reinsured a proportion of the US$15 million risk with, amongst others, Faraday. The reinsurance contract included a claims cooperation clause which stated:

> "*Notwithstanding anything contained herein to the contrary, it is a condition precedent to any liability under this Policy that:*
>
> *(a) The Reinsured shall upon knowledge of any loss or losses which may give rise to a claim, advise Reinsurers thereof as soon as is reasonably practicable and in any event within 30 days.......*".

On 6 September 2002 Smartforce merged with Skillsoft. On 19 November 2002 the management of the newly merged enterprise announced that it intended to restate the financial statements of Smartforce for the previous three years. This led to a fall in the listed value of Smartforce's shares. In March 2003 shareholders commenced class actions against Smartforce and various of its directors alleging that they had bought shares at artificially inflated prices and that they had lost money as a result.

On 22 September 2003 Smartforce filed its restated accounts. These showed a reduction in net income of approximately US$127 million and reduced shareholder equity of approximately US$81 million.

On 12 February 2004 AIG posted a reserve of US$7.5 million. The reserve represented a hit of US$2.5 million against the first layer of the reinsurance, of which Faraday reinsured 50%.

The claims were settled at mediation in March 2004 for US$30.5 million. A memorandum of understanding between the parties was signed on 23 March 2004. At this stage no agreement had been reached between Smartforce and AIG regarding the recovery under the insurance.

Faraday were notified of the loss on 19 April 2004.

In June 2005 AIG paid Smartforce's claim under the D&O Policy for the full limit of US$15 million and sought to recover under its reinsurance. Faraday refused to pay the claim. It argued that it was not notified in accordance with the claims cooperation clause. More specifically Faraday argued that:

- The clause obliged AIG to notify it of circumstances which might give rise to a claim against Smartforce, as well as actual losses, and that was not done as soon as reasonably practicable, or within 30 days of AIG's knowledge of the same.
- Even if the clause only covered actual losses, AIG were aware of the losses when it was announced that Smartforce were to restate its financial statements on 19 November 2002. Notification was not therefore given within 30 days.
- Even if the losses were notified within 30 days, Faraday were not notified as soon as was reasonably practicable.
- AIG knew that the claimant shareholders had incurred legal fees and that Smartforce had incurred defence costs. These were losses for the purposes of the policy.

The decision

The claims cooperation clause was very similar to that which was considered in *Royal & Sun Alliance v Dornoch* 2005. Mr Justice Morison considered the decision of the Court of Appeal in *Dornoch* and reached the same conclusion:

- Loss for the purpose of the claims cooperation clause was that of the shareholders who were the claimants in the class actions.
- Actual loss was required. The words "*loss or losses*" are essentially different from "*alleged*" or "*claimed*" or "*potential*" losses. If that was what was intended then the parties could have used such language.
- The claimants do not suffer an actual loss until it is proved that they bought shares at an inflated value due to the default of the company directors.

Accordingly, the task for the court was to decide when AIG had knowledge of an actual loss, ie, whether this was over 30 days before 19 April 2004, when Faraday were notified of the loss.

Mr Justice Morison decided that AIG did not know about an actual loss until, at the earliest, 23 March 2004, when the memorandum of understanding was agreed between the claimants and Smartforce. It was at that stage that a "*might be loss*" turned into an actual loss for the purposes of the reinsurance. Had there been no settlement there would have been no actual loss, as at the time of the mediation there had been no disclosure or exchange of expert reports and there was no sound basis for concluding that there was any liability or any proved loss. AIG's posting of reserves did not establish knowledge of a loss. Reserving was just a process by which insurance companies anticipate the possibility of a loss in a policy. In the circumstances, AIG had notified Faraday within 30 days of it becoming aware of an actual loss.

Mr Justice Morison commented that he suspected that the issue of costs had only been raised to support the argument that "*loss*" meant "*potential loss*". The loss referred to in the claims cooperation clause was the third party claimants' loss attributable to the acts or defaults of the directors for which there was cover under the D&O Policy. It did not include the costs incurred by the claimants in proving their claim. In any event, on the facts, the settlement of the claims between Smartforce and AIG did not include a payment for such costs. Likewise, AIG were never asked to make any contribution to Smartforce's defence costs, so no indemnity would be available in respect of these.

Faraday had also argued that the claims cooperation clause consisted of two conditions precedent, each of which must be fulfilled. First, to advise as soon as reasonably practicable and, secondly, to advise within 30 days. Mr Justice Morison dismissed this argument as "*hopeless*". If that had been the intention behind the clause that should have been spelt out. In any event notice was given within 30 days and as soon as reasonably practicable.

Comment

In his judgment Mr Justice Morison took the opportunity to add to the growing criticism of the decision in *Lumbermans Mutual Casualty Co v Bovis Lend Lease* 2004, although his comments were obiter dicta. In the *Lumbermans* case it was decided that an insured could not rely on a settlement agreement covering both insured and uninsured losses as establishing insurers' liability, if the settlement did not make an

attribution between insured and uninsured losses. Arguably the same principle would apply to a reinsured seeking to make a recovery under a reinsurance contract.

Mr Justice Morison doubted the "*controversial*" decision in *Lumbermans* and agreed with the comments made by Mr Justice Aikens in *Enterprise Oil v Strand* 2006. Namely that the "*flaw*" in the *Lumbermans* case was that the judge had rejected that extrinsic evidence could be used to explain the losses in a global settlement. Mr Justice Morison doubted that the decision in *Lumbermans* was correct but, in any event, he did not think that it could apply to a reinsurance case where there was a follow the settlements clause. However, until the decision in *Lumbermans* is overruled, reinsureds would be advised to ensure that any global settlement apportions liability between different heads of loss and insured and uninsured eventualities.

IBNR value in US insolvencies: IN RE: INTEGRITY INSURANCE COMPANY, Superior Court of New Jersey Appellate Division, United States, 2 October 2006

The State of New Jersey Appellate Court ruled that the final dividend plan ("**FDP**") proposed by the liquidator for Integrity Insurance Company ("**Integrity**") was invalid in part because incurred but not reported ("**IBNR**") claims were improperly included in the valuation of claims by its policyholders.

As background, Integrity wrote umbrella and excess liability insurance policies which covered long-tail liabilities prone to significant IBNR. These underlying policies were reinsured by various companies. In 1987, Integrity was placed into liquidation with over 26,000 policyholder claims filed. The liquidator allowed US$598,000,000 in paid claims and an estimated liability of US$2,055,335,000 in respect of claimants who had not presented specific losses. Under the FDP, the Liquidation Court could approve claims for IBNR which were deemed to be absolute and which had been determined by qualified personnel employing certain standard practices and procedures. The liquidator for Integrity successfully obtained the lower court's permission to approve the FDP.

The Reinsurance Association of America ("**RAA**") challenged the lower court's holding which permitted the liquidator for Integrity 1) to estimate IBNR claims for policyholders on an actuarial basis and 2) to compel Integrity's reinsurers to pay the computed IBNR sums in accordance with the FDP.

The RAA argued 1) that IBNR losses did not constitute a "*claim*" within the meaning of the relevant insurance and reinsurance policies nor within the Insurer Liquidation Act ("**ILA**") (which governs the liquidation of insolvent insurance companies in New Jersey), and 2) that IBNR losses can never meet the conditions precedent to payment imposed by the ILA.

Under section 17:30C-28A of the ILA, a claimant making a contingent claim can only share in the distribution of the assets of an insolvent estate if it is deemed to be an "*absolute*" claim against the insolvent company. The court considered the dictionary definition of the term "*absolute*" which is defined as, "*free from restriction, qualification, or condition; conclusive and not liable to revision*". It held that IBNR claims are actuarial estimates and are, therefore, not absolute. Thus, the statute prohibits IBNR claims from sharing in the estate.

The exception under section 17:30C-28b of the ILA provides that a contingent claim may be admitted into the estate if the claimant would be able to obtain a judgment in respect of the claim against the estate. However, the court held that IBNR could not fall within this exception since, by its very nature; IBNR represents bulk claims of all potential claimants and demonstrates only that historical experience suggests the insurers might have to pay an amount approximated actuarially. Therefore, the court refused to admit IBNR claims as an established claim in an insolvent estate where the losses were not capable of being sufficiently ascertained to reduce to a judgment.

Lastly, the court considered testimony from industry experts which unanimously confirmed that the IBNR estimates would not achieve "*100 percent accuracy*". It observed that: "*IBNR estimates in the industry are limited to voluntary agreements relating to matters such as mergers and acquisitions, extensions of credit, selling reserves, and filing tax returns.*"

Accordingly, the court held that IBNR claims could not share in any final distribution from the Integrity estate. While the liquidator has substantial discretion in choosing a mechanism for closing the estate (ie,

the FDP), the court held that she could not select one which contravened the plain language of the ILA. The court determined that the provisions of the FDP permitting the use of IBNR losses were invalid.

Comment

The New Jersey Court's decision in this case is contrary to the movement in the UK to promote the closure of solvent and insolvent estates. For example in the UK, companies in a scheme will often receive a court sanctioned crystallization of the creditors' claims. In particular, this valuation process by the scheme administrator will include case reserve and IBNR totals where appropriate. In this case, it is suggested that US courts are not sympathetic to creditors of an estate carrying balances attributable to IBNR. A practitioner in this industry would be wise to negotiate a commutation with insolvent estates in the US before a court or liquidator decides that a final dividend will include no value for IBNR claims.

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Louisiana "flood" exclusions do not catch damage from levee collapse – IN RE KATRINA CANAL BREACHES CONSOLIDATED LITIGATION, Louisiana Eastern District Court, 6 December 2006

In a recent decision that could affect London market reinsurers, the Louisiana Eastern District Court was asked to determine the effect of exclusions appearing in a number of homeowners/all risk insurance policies. The policies were underwritten by a number of different insurers and included materially identical terms based on standard insurance policy wording recommended by the Insurance Services Office, Inc (the "**ISO**"). The ISO is an American body which provides products and services to help the insurance industry to measure, manage and reduce risk.

The policies excluded damage caused by *"flood, surface water, waves, tidal water, overflow of a body of water, or spray from any of these, whether or not driven by wind"* (the "**ISO Exclusion**"). The policyholders argued that the ISO Exclusion did not apply because the "*efficient proximate cause*" (applying Louisiana law) of the damage was the breach of canal walls in New Orleans during Hurricane Katrina, which was caused by their being negligently maintained. The damage was therefore a manmade (as opposed to natural) cause.

Some of the policies contained further exclusions in addition to the ISO Exclusion.

For example, before reciting the ISO Exclusion, a State Farm & Cas Co ("**State Farm**") policy included a "*lead in*" provision which stated that cover was excluded for any loss which would not have occurred in the absence of one or more of the events cited in the ISO Exclusion, regardless of the cause of the excluded event.

A Hartford Ins Co of the Midwest ("**Hartford**") policy contained, in addition to the ISO Exclusion, a specific flood definition which provided that the policy should not cover (amongst other things) loss or damage caused by (a) the design, workmanship, repair, construction or compaction of drainage ditches, levees or dams or (b) the collapse, cracking or shifting of buildings or other structures if it occurred during flood conditions or within 72 hours after the flood conditions ceased and which would not have occurred but for the flood. Flood was defined to include both the ISO wording and *"release of water held by a dam, levy* [sic] *or dike or by a water or flood control device".*

The court stated that under Louisiana law "*all risks*" policies extended cover to all fortuitous losses, ie, risks that were not usually contemplated by the parties entering into the contract, unless there was a specific exclusion. In this case, coverage would be presumed unless there was a specific exclusion for the type of water damage that the insured had suffered. Since Louisiana law applied the doctrine of "*efficient proximate cause*", the court had to consider whether the exclusions were wide enough to include man-made causes arising from negligence or deliberate acts, or whether it should be restricted to flood resulting only from naturally occurring events. The court observed that exclusions must be narrowly construed. In the policies the word "*flood*" had been used as a noun, but its precise meaning

was ambiguous. Certainly the words immediately following "*flood*" in the exclusion were all synonymous with events.

The judge noted that although the wording of the ISO Exclusion was ambiguous, the State Farm and the Hartford policies successfully excluded coverage for negligent acts and omissions with very little effort. The State Farm "*lead in*" provision made it clear that regardless of the cause of the flooding (ie, whether or not it arose out of human negligence or not), there was no coverage and that all flooding was excluded from the scope of the policy. The Hartford policy left *"nothing to the imagination"* and acted as a specific exclusion for flood damage caused by negligently maintained levees. The court said that such a clear statement of exclusion from coverage in the Hartford policy must be enforced. Therefore if a consumer had read the wordings of all of the policies, he would reasonably be expected to have chosen the other ISO Exclusion policies over the State Farm or Hartford policies, since if the policies were compared it would be reasonable to assume that the ISO Exclusion policies only excluded coverage for natural acts, unlike the other two policies. The court stated that to find that the ISO Exclusion in itself excluded negligent acts would be to reward and encourage the use of vague language.

Comment

Although the court applied the Louisiana Civil Code and was interpreting a number of insurance policies where consumer protection was foremost in its mind, its decision may have potential implications for reinsurers who have reinsured Katrina flood damage risks. If the provisions of the reinsurance contracts were back-to-back with the terms of underlying insurance policies and incorporated the ISO Exclusion wording without any additional wording, reinsurers may find that they are bound to indemnify the underlying insurers. This may be despite the intentions of the insurer and the reinsurer at the time that the contract was placed that all flood damage (not just natural) was excluded.

The fact that the ISO Exclusion was drafted by an interstate American body but failed to specify that flood damage arising out of manmade causes is, perhaps, of even greater concern. Before accepting a risk, reinsurers should take care when reviewing underlying insurance policies – particularly those covering all risks – to ensure that all intended exclusions are specifically set out. Reinsurers should not simply rely on the fact that wording is widely used by a particular country's insurance market and has been designed by a body committed to protecting insurers' interests.

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