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Insights

MUST REINSURERS FOLLOW THEIR CEDANTS' COVID-19 RELATED CLAIM SETTLEMENTS?

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Introduction

A key question being asked in the markets is whether reinsurers are obliged to follow their cedants' Covid-19 related settlements?

Covid-19 continues to dominate the headlines and the lives of people around the world. The global virus also raises novel issues for the (re)insurance industry. In our recent article, we considered the tricky issue of the potential to aggregate Covid-19 related losses as one "event" (you can find that article here). We now, in the second of a series of articles considering the impact of Covid-19 on the reinsurance market, examine another issue that cedants, in particular, will be grappling with, namely whether reinsurers are obliged to follow their settlements in relation to Covid-19 claims.

The obligation of a reinsurer to follow the settlements of its cedant is a common feature of reinsurance contracts. However, tension can arise after natural catastrophes or, as here, following global pandemics. Governments around the world can respond by changing the law, potentially resulting in the scope of reinsurance cover to change with it.

Political pressure

Enormous political pressure is being placed on the insurance industry, who are simultaneously facing an unprecedented level of claims across most classes of business. For example, on 16 March 2020, the New Jersey Assembly introduced a bill that, if passed, will require insurers to cover business interruption losses not covered by the plain language of their polices and/or that were expressly excluded from cover. Other US states, including Michigan and New York, have either introduced similar measures or have suggested that they may do so in the future.

Across the pond in the UK, Prime Minister Boris Johnson recently claimed that insurers have agreed not to "quibble" when presented with claims by policyholders who have cover for pandemics, raising the prospect of insurers waiving otherwise valid policy defences and settling claims. The FCA has also had its say, with the regulator warning that they "*expect insurers, given the*

unprecedented impact of coronavirus, to be aware of the circumstances that their customers find themselves in". It is in this context that we now consider reinsurers' obligation to follow the Covid-19 related settlements of their cedants.

Judicial guidance on 'follow' clauses

In principle, it is settled English law that a cedant can establish its liability for reinsurance recovery purposes, by settlement of their insureds claim or by a judgment or arbitration award that determines that they are liable. This article considers what is required to ascertain Covid-19 related liabilities by way of settlement.

Ordinarily an insured and its insurer reach agreement as to the claim and settlement amount and payment is made accordingly. In the absence of a true follow the settlements clause, in order to make a claim against their reinsurer, a reinsured is required to prove that the loss falls within the terms of both the (inwards) original policy and the (outwards) reinsurance contract. The position is akin to a contract that contains a (*Hill v M&G)* 'double proviso' follow obligation (the loss must fall "within the terms of the underlying and within the terms of the reinsurance"). In these circumstances, a cedant has the burden of establishing that it was liable at law for the underlying settlement reached.

Conversely, in the leading decision on unqualified 'full follow' type clauses, (*Insurance Company of Africa v Scor)*, the Court determined that the effect of such a provision was that reinsurers agree to indemnify insurers in the event that they settle a claim 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. in settling the underlying claim the insurer has acted honestly and has taken all proper and businesslike steps in making the settlement (the second proviso).

Thresholds of proof

Accordingly, a lower standard of proof applies to establishing underlying liability in contracts that include a *Scor* type follow provision compared with a *Hill v M&G* type clause (or where there is no 'follow' clause at all). One can therefore see how the nature of any government or regulatory intervention following the outbreak of Covid-19 has the potential, in certain circumstances, to affect cedants' recoveries from reinsurers. This is particularly relevant where insurers in the UK pay claims where arguably there may be no underlying liability, but external influences result in claims being settled. This can be contrasted to the position in the US where insurers might face being legally obliged to pay claims that otherwise would not be covered.

First proviso

The first proviso provides that it is necessary for the loss to fall with the terms of the reinsurance contract. This means that the reinsurer is not allowed to reopen the settlement of the underlying claim. But the reinsurer is not precluded from arguing that the reinsurance contract does not cover the underlying settlement. The first proviso was considered in *Generali v CGU International Insurance*, where the Court of Appeal considered the meaning of the words "the claim so recognised" in circumstances where the reinsurance provided back-to-back cover:

"*…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 so…*"

It is therefore clear that to satisfy the first proviso in a *Scor* type 'follow' clause, the claim has to be only arguably covered by the reinsurance contract.

Second proviso

Turning to the second proviso, all that is necessary is that the reinsured took proper and businesslike steps in determining whether there was a serious possibility that the policy covers the insured's claim and there is no defence available against it. For example, the instruction (and thereafter adequate supervision) of a competent loss adjuster is good practice.

Proving liability on the inwards and outwards

Returning to the 'double proviso' type clauses, what is the level of proof that a reinsured has to meet to prove that they have settled an underlying liability (e.g. where there is a Hill v M&G provision or no 'follow' clause)? In *Commercial Union (CU) v NRG*, CU sought summary judgment against its reinsurers, NRG, concerning a claim in respect of the Exxon Valdez oil disaster. NRG argued that CU was not legally liable to pay Exxon because they had settled purely on advice from their Texan lawyer that, although CU had an arguable defence in law, had the case proceeded to trial, they would nevertheless have been unsuccessful in front of a Texas jury. The Court of Appeal agreed with NRG; they ruled it was not enough for CU to establish that the settlement was business-like and sensible with this type of clause .

Under the *Hill v M&G* style 'follow' clause in the reinsurance contract, the settlement was binding only if it was within the terms and conditions of both the original policy and of the reinsurance, and for that purpose it was not sufficient to rely on the advice of a lawyer that a jury may find against them. The question of whether it was arguable that reinsurers might not be liable to their reinsureds was for the Court to decide, based on the proper construction of the policies according to the applicable law.

However, a question left open by *CU v NRG* was the extent to which the settlement of a claim under an original policy subject to foreign law is within the terms and condition of that policy for purposes of a 'loss settlements binding' clause where the settlement represents a compromise of a difficult point of law which, according to the reinsured's legal advisors, is equally to be decided for or against the reinsured.

In *Luria Brothers v Alliance Assurance*, it was decided, as a matter of New York law, that it is open to an insured to determine its legal liability by way of settlement rather than proceeding to trial.

"*When an insurer declines coverage, as here, an insured may settle rather than proceed to trial to determine its legal liability. In order to recover the amount of the settlement from the insurer,* ***the insured need not establish actual liability*** *to the party with whom it has settled so long as … a potential liability on the facts known to the [insured is] shown to exist, culminating in a settlement in an amount reasonable in view of the size of the possible recovery and degree of probability of claimant's success against the [insured].*

On the facts known to Luria at the time of the settlement, Luria had potential liability to the death claimants" (emphasis added).

Accordingly, the US Court held that insurers **are** liable (as a matter of New York law) to indemnify an insured in respect of a settlement it has reached, provided that:

- a potential liability existed, on the facts known to the insured; and
- the settlement was "reasonable" considering the potential recovery and the degree of probability of third party claimants succeeding in their claim against the settling party.

Arguably liable or on a balance of probabilities?

Helpfully, the question of what level of evidence is required to establish an underlying claim has also been considered recently by the English Courts, notably in *AstraZeneca Insurance v XL Insurance and Ace Bermuda* and *Tokio Marine v Novae.* The underlying losses in *AstraZeneca* concerned liability insurance, while the *Tokio Marine* decision concerned underlying property damage and business interruption losses. Both are relevant to potential Covid-19 related claims. Both cases also concerned "back to back", facultative reinsurance and highlight the different standard of proof that is required for different 'follow' clauses.

In addressing materially different follow clauses, the *AstraZeneca* and *Tokio Marine* decisions nevertheless affirm English law principles from earlier authorities (including those referenced above) regarding the standard of proof required to prove underlying liability. In particular, the wording "liability imposed by law" means precisely that: in the absence of any qualifying provisions, any reference to "liability" means "actual liability", not "alleged" or "arguable" liability.

However, as was the case in *Tokio Marine*, parties to contracts of reinsurance (or retrocession) can agree that proof of "actual liability" is not required or, alternatively, that obligation is replaced with less onerous terms. For example, various forms of follow clauses used by the London market bind reinsurers to follow the claims settlements effected by the reinsured without requiring proof of "actual liability" for such settlements under the terms of the original insurance.

Where a reinsurance contract contains a follow clause which renders settlements binding subject to compliance with the *Hill v M&G* "double proviso" (as discussed above), reinsurers are free to question whether the claim is, in law, covered by both the insurance and the reinsurance. But where a facultative reinsurance (or retrocession) contract contains a *Scor* follow clause of the kind also under consideration in *Tokio Marine*, then aside from the requirements to effect settlements honestly and in a proper and business-like manner, a reinsured need only prove that the claim it has recognised under the original insurance contract is: (i) "arguably" covered at law under the insurance contract; and (ii) where the coverage provided under the reinsurance contract is identical to that of the insurance contract, "arguably" covered at law under the reinsurance contract.

Of course, there are other variants of these types of 'follow' clauses, for example those including (or expressly excluding) ex-gratia and/or without prejudice settlements. These types of 'follow' clauses will also be relevant to Covid-19 related claims.

Covid-19 claims

So where does this leave cedants and reinsurers with regard to Covid-19 related losses? As is unfortunately so often the case, there is no straightforward answer. The position will turn on the contractual wording and, in particular, the terms of any 'follow' obligation.

However, given that US states are now moving to impose legal liabilities on insurers where previously there were none, reinsurers are likely to be presented with claims that they are obliged to follow, notwithstanding that at the time the reinsurance (or retrocession) contract was agreed, such losses would not have been covered as a matter of law.

Conversely, where, under political pressure, insurers in the UK agree claims where there is arguably no, or no actual, legal liability then insurers may be unable to pass on those losses to their reinsurers, even where the reinsurance contract contains a follow clause. As losses continue to accumulate across many classes of business, only time will tell the impact these issues will have on the market as a whole.

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