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The Companies Act — A New Era?

John Barlow, in London

Readers familiar with UK company law will not have missed the recent flurry of commentaries in connection with the Companies Law Reform Bill. This was finally enacted on the statute books on 8 November 2006, although the provisions discussed in this article are subject to consultation during February 2007 regarding their implementation and are expected to come into force by late 2007.[1]

The Companies Act 2006 ("the 2006 Act") marks the most significant consolidation of company law in the last 20 years. There is no doubt that the 2006 Act is an impressive document at 500 pages in length and containing 1,300 sections. The principal aim behind the Act is to modernise UK company law and to "engage" shareholders in the governance of their company. A further issue that the 2006 Act addresses is the Government's concern that as the business environment evolves, existing statute and case law is becoming increasingly dislocated from the operating reality of companies (particularly private companies).

Much has been written about the potential impact of the 2006 Act and this article considers the statutory liabilities under the 2006 Act that affect directors and the means by which claims may be made against them under the new regime. To be sure, there are aspirational provisions contained in the 2006 Act — however, the question remains as to whether they will have any significant impact on the modern director?

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Overview

Directors should be under no illusion that the regulatory environment has developed immeasurably over the last two decades. Whilst in broad terms, directors' duties of care have been well developed over many years (principally through the courts, rather than statute), the recent trend has been to enshrine liabilities in statute (much of the impetus for this has come, not surprisingly, from the EU with an emphasis on codification and standardisation of legal regimes, rather than / continued page 2

[1] The principal reason for the delay in implementation is that much of the subsidiary legislation has yet to be drafted.

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the evolution of precedent based law). Thus, recent years have seen the passing of an unprecedented number of statutes and regulations, principally concerned with the financial transparency of companies. By way of example, the Companies (Audit, Investigations and Community Enterprise) Act 2004 (which is incorporated into the 2006 Act) requires directors of quoted companies to make certain disclosure statements in the directors' report and, in effect, to certify that there is no relevant information of which the auditors should be aware. Ignorance and/or inactivity on the part of a director is no longer an excuse. In addition, there is a plethora of other statutes and regulations that affect directors, from the market abuse regime in Part VIII of the Financial Services and Markets Act 2000, the criminal liabilities contained in the Theft Act 1968 through to the Combined Code and Model Code requirements appended to the Listing Rules issued by the UK Listing Authority.

This article considers the general duties that are prescribed in the 2006 Act (sections 170-177), the effectiveness of those duties and the enforceability of such duties.

The General Duties

The 2006 Act specifies a number of directors' duties (arising from their fiduciary capacity towards the company concerned), the majority of which were previously addressed by English common law:

- to act within powers conferred on them (s.171)
- to promote the success of the company (s.172)
- to exercise independent judgment (s.173)
- to exercise reasonable care, skill and due diligence (s.174)
- to avoid conflicts of interest (s.175)
- not to accept benefits from third parties (s.176)
- to declare any interest in a proposed transaction or arrangement. (s.177)

Naturally, the 2006 Act contains the standard requirements/prohibitions for directors *e.g.*, controls over substantial property transactions; disclosure of shareholdings; restrictions on loans.

Given that many of these duties existed in common law prior to the 2006 Act, their reduction to statute law can hardly be classed as ground breaking save for, perhaps, the duty to promote the success of the company (s.172) and, arguably, the statutory formulation of the duty of care (s.174). Nevertheless, some of the reformulated duties make the approval of conflicts and declarations of interest easier (often dispensing with the members' approval unless required by the company's articles).

The 2006 Act makes clear that the general duties that are identified "*shall be interpreted and applied in the same way as common law rules or equitable principles, and regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties*." Accordingly, in order to interpret the ambit of these duties, regard must be had to existing court decisions with which company law practitioners will be familiar. It should also be borne in mind that the panoply of rules and regulations regarding the rather mundane processes of stewardship of a company *e.g.*, the filing of audited accounts and annual returns are also replicated and are accompanied by fines, penalties and the potential for disqualification.

For the purpose of applying these duties to a director, the definition of a director remains the same as that set out in the Companies Act 1985 ("the 1985 Act").[2] Naturally, the general duties also apply to those individuals who have ceased acting as directors *e.g.*, the duty to avoid conflicts of interest and not to accept benefits from third parties.

The Companies Act 2006 makes clear that the general duties that are identified "shall be interpreted and applied in the same way as common law rules or equitable principles, and regard must be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties." Accordingly, in order to interpret the ambit of these duties, regard must be had to existing court decisions.

2 A director "includes any person occupying the position of director, by whatever name called."

Perhaps the most interesting duty which will be placed on a statutory footing is the duty to promote the success of the company. Section 172 provides:

A director of a company must act in the way he considers, in good faith (emphasis added), would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to -
(a) the likely consequences of any decision in the long term,
(b) the interests of the company's employees,
(c) the need to foster the company's business relationships with suppliers, customers and others,
(d) the impact of the company's operations on the community and the environment,
(e) the desirability of the company maintaining a reputation for high standards of business conduct, and
(f) the need to act fairly as between members of the company. [3]

However, there are two fundamental issues which arguably render the section relatively ineffective:

(1) Directors' duties are owed to the company and not to its members or to third parties, such as employees or pressure groups (s.170(1)) (and the accompanying notes to the 2006 Act acknowledge the restricted ambit of the duties). This statement accords with, for example, the application of section 309 of the 1985 Act which addressed the duties of directors to employees and was always regarded as a toothless provision (as the duty was enforced by the company and gave employees no direct or indirect right of action to enforce the duty). Thus, operations which might have an environmental impact can only be challenged by the company (or by shareholders pursuant to a "derivative" action on behalf of the company), but not by third parties. Directors can still be held liable for breaches of environmental laws (*e.g.*, the Control of Pollution Act 1974), whether on the basis of criminal or civil liability.

(2) The commentary accompanying the 2006 Act notes that section 172 is intended to codify the current law (although it is difficult to discern which elements it is codifying given the relatively nebulous nature of some of these duties) and sets out the principle of "enlightened shareholder value." The commentary notes that the duty requires a director to act in good faith. Accordingly, what constitutes the success of a company is one for the director's good faith judgment. In practice, business strategies are to be determined by the directors and will not be subject to the interference of the court (save where they are not conducted in a good faith fashion), thus according directors significant latitude. This laissez-faire attitude to directors' decision making processes is reflected in decisions from the nineteenth century onwards where the English courts have been reticent about challenging entrepreneurial instincts.

[3] It should be noted that this list is not intended to be exhaustive.

Duty of Care, Skill and Diligence

As expected, the 2006 Act now contains a statutory test with regard to the duty of care which mirrors that contained in Section 214 (Wrongful Trading) of the Insolvency Act 1986 which sets the standard at:

"the care, skill and diligence that would be exercised by a reasonably diligent person with:
(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and
(b) the general knowledge, skill and experience that the director has."

Thus, the duties of a director are assessed against an objective, minimal benchmark (a), but can be enhanced by the subjective benchmark attributable to that particular director (b). However, mere evidence of imprudence, as opposed to negligence, will not be sufficient to fix a director with liability: such reasonable care *"must be measured by the care an ordinary man might be expected to take in the circumstances on his own benefit; he is clearly...not responsible for damages occasioned by errors of judgment."*
Lagunas Nitrate v Lagunas Syndicate [1899] 2 CH. 392 at 435.

The Enforceability of Directors' Duties

As noted above, directors' duties are owed to the company and not to individual members or third parties. Accordingly, a company can enforce these duties by one of three processes:

- the board resolving to commence proceedings
- the commencement of proceedings by a liquidator or an administrator (*e.g.*, pursuant to the Insolvency Act 1986) or
- the bringing of a derivative action by a member.

Prior to the 2006 Act, the general principle in circumstances where a member sought to bring suit */ continued page 4*

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against the director (or in limited circumstances, a third party) was set out in the rule in *Foss v. Harbottle (1843) 2 Hare 461*. It is for the company to bring the proceedings where a wrong has been done to the company. This was principally a rule of *locus standi*. Limited exceptions existed where there had been a "fraud on the minority" *e.g.*, where the company was prevented from bringing proceedings because the director against whom the action could be maintained was a majority shareholder; an act was *ultra vives* the company or an act infringed the rights of an individual shareholder.

The new procedure for bringing derivative claims (sections 260-264 of the 2006 Act) is not intended to provide a substantive rule to replace *Foss v. Harbottle*, but to provide a new derivative procedure by which members may bring claims for a breach of the duty to exercise reasonable care, skill and diligence (which is broader than the previous basis for bringing such claims). The procedure involves a two stage approach and is intended to filter out unmeritorious or frivolous claims:

(1) the member will be required to make out a *prima facie* case for permission to bring the derivative claim. In doing so he must establish (1) he/she is a member of the company; (2) the cause of action is vested in the company, and (3) the relief is sought on the company's behalf. If a *prima facie* case cannot be established, the claim will be dismissed.

(2) If the member overcomes the first hurdle, and before the substantive case is heard, the court may require evidence to be filed by the company.

The court, on hearing evidence from the company, may allow the proceedings to continue on specified terms. The 2006 Act also provides that where the company has instituted proceedings against a director to frustrate the bringing of other claims then the court may, in effect, order the transfer of the case to the member for him/her to prosecute.

It should be noted that the 2006 Act replicates the old s.459 provision under the 1985 Act (protection of company's members against unfair prejudice) and the derivative procedure likewise applies to this statutory relief.

Conclusion

Will the 2006 Act when implemented represent a significant leap forward in terms of directors' liabilities? The simple answer is "no". The 2006 Act (insofar as it impacts directors) represents a consolidation/codification of the existing statutory/common law regime and contains few significant innovations save for arguably, section 172. Whilst that section contains a laudable desiderata of duties, the limited group to whom duties are owed, the nebulous nature of the duties, the enforceability of such duties and the application of good faith to these duties does call into question whether the 2006 Act will have a significant impact on the modern director. ◎

Brazil Enacts Law Ending IRB's Monopoly

Carlos Fane, in London, and Marcia Cicarelli Barbosa de Oliveira, JBO Advocacia, in Brazil

The writing of reinsurance for Brazil's domestic market has been the monopoly of the state-controlled Instituto de Reasseguros do Brasil ("IRB") since IRB's creation by Brazil's government in 1939.

In recent months, Brazil's legislature has been considering a bill — Law 249 — providing for the breaking up of this monopoly. On 15 January 2007, following approval by Brazil's lower and upper houses, the bill was enacted and came into force.

As a result of this act, the status of IRB will be downgraded to that of a "Local" reinsurer (see below) and foreign reinsurers will, for the first time, be able to participate directly in the Brazilian reinsurance market. As Brazil accounts for nearly 50% of Latin America's insurance activity, this is a significant development.

A previous law, passed in 1999, paving the way for the privatisation of IRB, fell prey to a legal challenge to its constitutionality, by the then opposition Workers Party ("PT"), which raises the question of whether the new law will suffer a similar fate. This seems unlikely, for several reasons. First, the way in which the new law was enacted — by means of a "complementary law" — means that its constitutionality cannot be challenged on the same basis as the constitutionality of the 1999 law. Second, the political climate in Brazil today is much less hostile to such liberalising measures than it was when PT mounted its legal challenge to the 1999 law. Perhaps the best illustration of this is that Brazil's President Lula De Silva, who gave final approval to the new law, is one of PT's founding members.

Law 249: Its Main Effects

The law permits three types of reinsurance companies to operate in Brazil (art. 4[1]):

- "Local reinsurers": local reinsurance companies registered in Brazil;
- "Admitted reinsurers": reinsurance companies registered outside Brazil but with a representative office in Brazil; and
- "Occasional reinsurers": reinsurance companies registered outside Brazil.

"Admitted" and "Occasional" reinsurers will be subject to the following regulatory requirements:

- authorisation, in the jurisdictions in which they are registered, to underwrite risks locally and internationally (art. 6.I).
- operational experience of at least three years in the jurisdiction in which they are registered and five years internationally (art. 6.I).
- a minimum financial capacity at the level to be set by the regulatory body to which the IRB's current regulatory powers are to be transferred (which is likely to be the Brazilian Superintendent of Private Insurance ("SUSEP")) (art. 6.II).
- a minimum solvency rating, to be set by the same regulatory body (art. 6.III).
- the appointment of an attorney in Brazil for service of judicial notifications and summons.

Admitted reinsurers will be subject to the following additional regulatory requirements:

- registration with SUSEP.
- maintenance of a bank account in Brazil in the currency of the country in which the Admitted reinsurer is registered.
- the periodic filing of financial reports with the regulatory body to which the IRB's current regulatory powers are transferred (again, likely to be SUSEP).

For the three years following the law's enactment, local insurance companies will be able to cede up to 40% of risks to reinsurers registered outside Brazil (*i.e.*, either Admitted or Occasional reinsurers). This figure will then rise to 60% during the following three years and is expected to increase further after that (art. 11).

Admitted and Occasional reinsurers, like Local reinsurers (including IRB), will be subject, *mutatis mutandis*, to the same laws as apply to Brazilian insurance companies. In practice, this is likely to mean that, for example:

- Reinsurance contracts will have to be approved by SUSEP.
- Reinsurance contracts will have to include Brazilian jurisdiction and governing law clauses.
- Reinsurance contracts will have to include a provision preventing the reinsurer from relying on the reinsured's insolvency to evade full liability for a reinsurance claim.

For the three years following the law's enactment, local insurance companies will be able to cede up to 40% of risks to reinsurers registered outside Brazil. This figure will then rise to 60% during the following three years and is expected to increase further after that.

Conclusion

Moves towards the modernisation of the Brazilian insurance and reinsurance market now seem unstoppable.

The IRB has already undergone major changes to prepare it for the opening up of the Brazilian reinsurance market: for example, the introduction of new technology, improved risk management techniques and new training for employees. There have also been visits by representatives of the Brazilian market to India and China to learn how similar reforms have worked there.

These changes create significant business opportunities for foreign reinsurers. The challenge will be to exploit these opportunities while avoiding the pitfalls created by the local regulatory regime.

[1] The references to articles refer to articles in the Law 249 bill.

2006 Reinsurance Decisions In Review

"Follow the Settlements" and "Follow the Fortunes" Clauses in U.S. and English Courts

Nancy Monarch and Anne Linder, in Washington, and Mark Pring, in London

"Follow the settlements" and "follow the fortunes" clauses have been interpreted to embody the principle which some believe is "understood to inhere in reinsurance generally,"[1] that a reinsurer will indemnify its cedents for any losses within the terms of the underlying policy, so long as the cedent has acted in good faith. Such clauses primarily operate for the benefit of cedents, allowing them some measure of certainty in calculating expected reinsurance recoveries and discouraging reinsurers from challenging a cedent's coverage decisions. Occasionally, though, disputes do arise regarding the scope of the obligations of a reinsurer who has agreed to "follow the fortunes" or "follow the settlements" of a cedent.

Recent decisions by U.S. and English courts have given different interpretations and effects to "follow the settlements" and "follow the fortunes" clauses in deciding under what circumstances a reinsurer is not obligated to pay its share of claims settlements made by the ceding company under the reinsured policy. In U.S. court cases these two clauses have been construed as interchangeable in the settlement context, and to place upon the reinsurer the burden of proving that the ceding company's settlement decisions are not entitled to deference because the ceding company did not act in good faith or because its claims investigation was not conducted in a reasonable and business-like manner.

In England, by contrast, the distinction between "follow the settlements" and "follow the fortunes" clauses is more carefully preserved and the reinsurer has potentially greater leeway to challenge liability under such clauses. Further, so far as the obligation to "follow the settlements" is concerned, the English courts have long recognized what has been described as the "tension of reinsurance".[2] This involves balancing the need to avoid two separate investigations into the same issues as against the need to ensure that the reinsurer is not obliged to indemnify its cedent in respect of a settlement that was not contemplated under the terms of the reinsurance contract. It is now well-established under English law that the reinsurer cannot be held liable — even where a "follow the settlements" clause is in place — unless the relevant loss falls both within the terms of the underlying cover and the terms of the reinsurance.[3]

The key question is then how the cedent *proves* that these requirements have been met. As explained below, the answer, perhaps not surprisingly, depends upon the terms of the "follow the settlements" clause itself and the English courts have steered clear of stating any further, general principles.

Recent U.S. Court Decisions

U.S. courts have said that the purpose of "follow the settlements" clauses is to "prevent reinsurers from secondguessing good-faith settlements and obtaining de novo review of judgments of the reinsured's liability to its insured." *North River Ins. Co. v. CIGNA Reinsurance Co.*, 52 F. 3d 1194, 1199 (3d Cir. 1995). The "follow the settlements" doctrine "creates an exception to the general rule that contract interpretation is subject to de novo review" by the courts. *Id*. at 1206. Absent exceptional circumstances, the ceding company's interpretation and application of its policy to the underlying claim cannot be revisited by reinsurers or the courts. The following discussion highlights the treatment of "follow the settlements" and follow the fortunes" clauses by U.S. courts in recent decisions.

In *Houston Casualty Co. v. Lexington Insurance Co*., No. 05-1804, 2006 U.S. Dist. Lexis 45027 (S.D. Tex. June 15, 2006), Lexington Insurance Company, a retrocessionaire of Houston Casualty Company, denied liability under a retrocession contract for the settlement of a business interruption claim arising out of the forced closure of a Florida theme park in the face of an impending hurricane. Lexington contended that the claim was not covered under the original all-risk policy issued

1 Edmond Rondepierre et al., "Reinsurance: Indemnifying Insurers for Insurance Losses," in *Reinsurance* 25 (Strain rev. ed., 1997). Some commentators believe that these two clauses have different purposes and that "follow the fortunes" does not apply to settlements.

2 Lord Mustill, in *Hill v. Mercantile & General Reinsurance Co. Plc* [1996] 1 WLR 1239 (HL).

3 So far as London market excess of loss treaties are concerned, this is usually reflected in the wording in any event. In *Hill*, the English courts considered the standard *"All loss settlements by the reinsured shall be binding upon reinsurers provided that such settlements are within the terms and conditions of the original policies and within the terms and conditions of this [reinsurance]".*

by the policyholder's captive insurer. The policyholder had submitted a claim under its policy for damages for business interruption, property damages and related expenditures which resulted when it was forced to close the theme park in response to a mandatory evacuation order issued by the Florida government in the face of a hurricane threat. The hurricane took another route — avoiding the theme park — but the park was closed and lost money. The theme park owner was insured through a captive which, through an unaffiliated management company, investigated the claim and paid the adjusted claim, less a deductible. The captive then sought payment from its reinsurers, including Houston Casualty. Houston Casualty paid its share of the claim settlement but its retrocessionnaire, Lexington, refused to indemnify Houston Casualty under the retrocession contract. Lexington contended that the claim was not covered by the underlying all-risk policy because, among other things, the theme park did not suffer physical damages to its property and the deductible had not been satisfied.

Both Houston Casualty's facultative reinsurance agreement and the Lexington retrocession contract contained identical "follow the settlements" provisions, which stated that the agreements were, "[s]ubject to all terms, clauses and conditions as original and to follow the settlements of original Underwriters in all respects within the terms of this reinsurance." *Id*. at 3-4. Houston Casualty moved for summary judgment, contending that Lexington's defense, based on the contention that the claim was not covered by the direct policy, was barred by the "follow the settlements" clause. Lexington also moved for summary judgment. Both motions were heard by a magistrate judge who ruled in favor of Houston Casualty.

In his opinion and recommendation, the judge noted that neither party argued that there was a material difference between "follow the settlements" and "follow the fortunes" clauses:

The follow the settlements doctrine is also known as the follow the fortunes doctrine. The parties have used the terms interchangeably, and do not argue that there is any difference between the two. The policy uses the phrase "follow the settlements." *Id.* at 9 n.8.

"Pursuant to this doctrine," the judge continued, "a reinsurer is required to indemnify its reinsured for payments that are reasonably within the terms of the original policy as long as the reinsured acted in good faith." *Id*. at 11 (citations omitted). The judge opined that the "follow the settlements" doctrine

> prevents facultative reinsurers from second guessing good-faith settlements and obtaining de novo review of judgments of the reinsured's liability to its insured. . . . Thus, "a reinsurer is required to indemnify for payments reasonably within the terms of the original policy, even if technically not covered by it." *Id*. at 10-11, quoting *Nat'l Am. Ins. Co. v. Certain Underwriters at Lloyd's London*, 93 F. 3d 529, 535 (9th Cir. 1996) (quoting *North River Ins. Co. v. CIGNA Reinsurance Co*., 52 F. 3d 1194, 1199 (3d Cir. 1995)).

Finding that the facts of the case did not involve exceptional circumstances necessary to meet the reinsurer's burden of proving that it is not obligated to follow the settlements of its reinsured, the magistrate recommended summary judgment in favor of Houston Casualty. The district / continued page 8

In *Houston Casualty* the magistrate judge opined that the "follow the settlements" doctrine "prevents facultative reinsurers from second guessing good-faith settlements and obtaining de novo review of judgments of the reinsured's liability to its insured...."

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judge adopted the magistrate's opinion and recommendation, granting summary judgment for Houston Casualty. *Houston Cas. Co. v. Lexington Ins. Co.*, No. 05-1804 (S.D. Tex. July 11, 2006), *available at* https://ecf.txsd.uscourts.gov/ cgi-bin/DktRpt.pl?463020052002145-L_353_0-1.

In *National Union Fire Insurance Co. v. American Re-Insurance Co.*, 441 F. Supp. 2d 646 (S.D.N.Y. 2006), the court undertook a similar analysis in deciding that the facultative reinsurer was bound to pay its share of the direct insurer's settlement of certain products liability claims. In that case the reinsurance agreement contained a "follow the fortunes" clause rather than a "follow the settlements" clause. In evaluating the reinsurer's objection to paying its share of the settlement, the court interpreted the "follow the fortunes" clause as having the same effect, in the settlement context, as a "follow the settlements" clause.

The cedent, National Union Fire Insurance Company ("National Union"), issued a commercial general liability policy to a machine manufacturing company. American Re-Insurance Company ("American Re") provided facultative reinsurance for National Union's policy. The policyholder was sued for personal injuries allegedly caused by metalworking fluids it manufactured. Eventually the claims against the policyholder were settled for approximately $19 million. *See National Union Fire Insurance Co. v. American Re-Insurance Co.*, 351 F. Supp. 2d 201, 205 (S.D.N.Y. 2005). National Union paid the claim and then sought indemnification from American Re for the reinsurer's portion of the loss under the facultative certificate.

American Re declined to pay, claiming, among other things, that it was not obligated to pay because (1) certain of the underlying claims were not covered by National Union's policy, (2) National Union's allocation of certain claims to the policy reinsured by American Re was unreasonable and (3) National Union had acted with "reckless indifference" to American Re's interest. The court granted National Union's motion for summary judgment holding that "American Re is required to follow the fortunes of National Union unless National Union paid a settlement that was 'clearly or manifestly outside the scope of the reinsured's policy coverage.'" *National Union*, 441 F. Supp. 2d at 651, citing *National Union*, 351 F. Supp. 2d. at 212 (citing cases). Finding that National Union's settlement was at least arguably within the scope of the policy, the court concluded that American Re's agreement to "follow the fortunes" of the ceding company obligated it to pay its share of the settlement.

In *National Union* the federal court stated that the reinsurer's challenges to the ceding company's allocation decisions invite "exactly the type of inquiry... that the follow-the-fortunes doctrine is intended to prevent," and that permitting reinsurers to "second guess [the propriety of the cedent's allocation] 'would make settlement impossible and reinsurance itself problematic.'"

On similar grounds the court also rejected the reinsurer's challenge to the settled allocation of the settled claims to the reinsured policy, holding that the allocation was "at least arguably correct, and therefore... could not have been unreasonable." The court stated that the reinsurer's challenges to the ceding company's allocation decisions invite "exactly the type of inquiry [by the reinsurer and court] that the follow-the-fortunes doctrine is intended to prevent," and that permitting reinsurers to "second-guess [the propriety of the cedent's allocation] 'would make settlement impossible and reinsurance itself problematic.'" *Id*. at 652, citing *Travelers Cas. & Surety Co. v. Gerling Global Reinsurance Corp*., 419 F.3d 181, 189 (2d Cir. 2005).

The court also rejected American Re's assertion that National Union acted in bad faith in allocating the claims to the policy which American Re reinsured. It held that to survive summary judgment, such "bad faith" allegations require a reinsurer to make an "extraordinary showing of a disingenuous or dishonest failure" by the cedent and that a cedent was not required to choose an allocation that minimized its reinsurance recoveries in order to avoid a finding of bad faith. *Id*. at

653, citing *Travelers*, 419 F.3d at 191 (citing cases). American Re's bad faith allegations rested on differences in the coverage positions that National Union had taken in its dispute with its policyholder as compared to the coverage positions it adopted in allocating the settlement to the underlying policies. The court rejected the contention that this demonstrated bad faith and granted summary judgment to National Union.

Finally, in one 2006 U.S. case, a reinsurer was found *not* liable to its reassured for payment of its share of a settled claim, even though the reinsurance agreement contained a "follow the settlements" clause. *Karen L. Suter v. General Accident Insurance Co. of America*, No. 01-2686, 2006 U.S. Dist. LEXIS 48209 (D.N.J. July 14, 2006), was a reinsurance dispute arising from a products liability class-action settlement. The underlying policyholder, Pfizer Inc., manufactured and sold replacement heart valves in the early 1980s, during which time Integrity Insurance Company ("Integrity") was one of Pfizer's high level excess liability insurers. In the late 1980s and early 1990s, thousands of heart valve recipients sued Pfizer based on actual or anticipated malfunction of the valves. Among the claimants were valve recipients whose heart valves had not failed, but who claimed they suffered anxiety caused by the prospect that the valves would eventually fail. Pfizer settled the bulk of the heart valve claims in 1992. The settlement included millions of dollars for the claims of valve recipients whose valves had not failed but who alleged they suffered anxiety because of the prospect of failure.

Pfizer did not actively pursue Integrity for coverage of these settled claims until 1999. By that time Integrity had been declared insolvent and had been in liquidation for over ten years, and its estate was being administered by New Jersey's commissioner for banking and insurance (the plaintiff in this case, Karen L. Suter). *Id*. at 1, 3-7. Integrity agreed to cover the Pfizer heart valve settlements under its early 1980's policies. The claims which Integrity agreed to cover included the claims of those whose heart valves had been implanted during Integrity's policy period even though the valves had never malfunctioned and the only injury claimed was anxiety that the valves might fail in the future. According to the Court:

> Integrity allowed anxiety claims that did not arise during the policy period based on when the [...] valve was implanted, which was during the policy period. *Id*. at 2.

Integrity billed its reinsurers for the settlement. One of Integrity's reinsurers, General Accident Insurance ("General Accident") which reinsured the 1982 and 1983 Integrity policies, refused to reimburse Integrity for this settlement on the grounds that certain of the heart valve claims were not covered by the Integrity policies, and that Integrity had not taken a proper and businesslike approach in its investigation of those claims. *Id*. at 2-3.

General Accident asserted that (1) Integrity's allocation based on "date of implant" was unreasonable because the alleged injury — anxiety that the valve was defective — did not occur on implant but much later; (2) there could be no coverage for such claims under the Integrity policies which only covered personal injury or property damage caused by an occurrence which took place during the policy period; and (3) Integrity had not acted reasonably or in good faith in allowing the claims, and that the lack of a proper and businesslike investigation by Integrity made the "follow the settlements" doctrine inapplicable. *Id*.

Integrity countered that General Accident was bound to pay its share of the settlement based on the "follow the fortunes" and "follow the settlement" clauses in the facultative reinsurance certificate which provided:

> [T]he liability of the Reinsurer [General Accident] . . . shall follow that of [Integrity] and except as otherwise specifically provided herein, shall be subject in all respects to all the terms and conditions of [Integrity's] policy. . . . All claims involving this reinsurance, when settled by [Integrity], shall be binding on the Reinsurer, who shall be bound to pay its proportion of such settlements, and in addition thereto, in the ratio that the Reinsurer's loss payment bears to [Integrity's] gross loss payment, its proportion of the expenses . . . incurred by the Company in the investigation and settlement of claims or suits . . . . *Id*. at 12-13.

Applying much the same standards articulated in *Houston Casualty* and *National Union*, the court concluded that the settled claims were not even arguably covered by the underlying Integrity policies and that Integrity had not conducted a reasonable, businesslike investigation before paying the claims. *Id*. at 82, 84-85. The court faulted Integrity for failing to retain its own coverage counsel to conduct a thorough and independent analysis of the coverage issues, and for ignoring what the court viewed as a key decision on the trigger of coverage issue in the underlying / continued page 10

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litigation between Pfizer and the claimants. The court also found that Integrity failed to obtain medical evidence to support the position that injury to the heart valve recipients occurred at the time the valve was implanted, i.e., during the Integrity policy period. The court suggested that Integrity should have sought an expert medical opinion on the injury issues, and that it was unreasonable for Integrity to accept the policyholder's changed position on coverage issues without any supporting evidence as to when the injury occurred. *Id*. at 76-77, 79, 82-84.

> The application of the "follow the settlements" doctrine is subject to the requirement that the reinsured make a reasonable, businesslike investigation. . . . Integrity did not make a reasonable, businesslike investigation and determination as to whether the heart valve claims should have been allowed. Consequently General Accident is not obligated to Integrity under the follow the settlements provision of its Facultative Certificate. *Id*. at 84, 86.

While *Houston Casualty* and *National Union* reflect U.S. courts giving broad effect to "follow the fortunes" and "follow the settlements" clauses in the context of the ceding company's settlements with its policyholders and allocation of those settlements to the underlying policies, *Suter* is a reminder that there are limits to the deference the ceding company can command.

English Court Decisions

Turning to the U.K., reinsurers have had more success in their coverage challenges, due at least in part to the English courts' narrower view of the scope and effect of "follow the fortunes" and "follow the settlements" clauses in reinsurance contracts. As already indicated, under English law, the effect of a follow the settlements clause in a reinsurance contract is, normally, that it removes the need for the cedent to prove actual liability at law to its assured (or cedent). Instead, the reinsurer agrees to indemnify the reinsured in the event that the latter settles any inwards claim, *provided that* (1) the claim falls within the risks covered by the reinsurance contract as a matter of law and (2) in settling the claim the reinsured has acted honestly and taken all proper and businesslike steps in reaching the settlement.

These key principles were established in *Insurance Company of Africa v. Scor (UK) Reinsurance Company Ltd*, [1985] 1 Lloyd's Rep. 312, and *Assicurazioni Generali SpA v. CGU International Insurance Plc*, [2004] Lloyd's Rep. IR 457.

How do they operate in practice? How can the cedent prove that these requirements have been met?

In *Insurance Company of Africa* in the English Court of Appeal, Lord Justice Robert Goff drew a distinction between (1) above — what the cedent has to demonstrate as a matter of law — and (2) above — what the cedent has to demonstrate as a matter of fact. The reinsurer is entitled to insist that claims paid by the cedent are proven to fall within the terms of the reinsurance as a matter of construction. On the other hand, it is not entitled to question settlements made by the cedent, so long as the cedent has acted in an honest, proper and businesslike manner. In addition, the burden of proof is on

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the *reinsurer* to establish that the relevant settlement was not honest, proper and businesslike. *Charman v. Guardian Royal Exchange Assurance Plc*, [1992] 2 Lloyd's Rep. 607.

In a recent case, *Faraday Capital Ltd. v. Copenhagen Reinsurance Co. Ltd.*, [2006] EWHC (Comm) 1474. The English courts demonstrated the practical significance of this distinction and the ability of reinsurers to challenge loss settlements as a matter of law. In the relevant reinsurance contract, the parties had expressly excluded "Without Prejudice and Ex Gratia Settlements." *Id*. at [5]. The reinsured (Faraday) had entered into a settlement with its insured which stated that it "shall not be construed as an admission of coverage ... under the Subject Insurance Policies" and was "without prejudice to the parties' positions." *Id*. at [17]-[18]. Copenhagen Re refused to indemnify Faraday, claiming that this was exactly the type of settlement excluded by the words added to the "follow the settlements" clause. Faraday argued that this would be inconsistent with the commercial purpose of the "follow the settlements" clause, which is "to avoid investigation of the same factual issues concerning the claim twice over, once by the insurer and again by the reinsurer." *Id*. at [31].

The court agreed with Copenhagen Re, finding that "the reinsurers are entitled . . . to insist that if the original insurer is not prepared to admit liability under the original policy then, for purposes of establishing the reassured's entitlement to recover under the reinsurance, the reassured must prove that there was, *in fact*, a liability under the original policy." *Id*. at [47]. Mr. Justice Aikens added that expressly excluding "without prejudice" and "ex gratia" settlements has the commercial purpose of providing "*encouragement to the original insurers/reinsured to give proper and businesslike consideration to its liability to the original assured and to act honestly in settling the claim*." *Id*. He noted that "[i]f all that is done, then, one asks rhetorically, why not admit liability to that extent and thereby come within the ambit of the 'follow the settlements' clause?" *Id*.

While much of the decision in *Faraday* relied upon the particular exclusion of "Without Prejudice and Ex Gratia Settlements," it is notable that the court engaged in a careful analysis of the meaning of each portion of the clause, including the meaning of the term "settlements" as "connot[ing] a concluded agreement between the 'original underwriters' and their assured. The word means a binding agreement." *Id*. at [45]. Where the settlements clause expressly precludes recovery by the reinsured in certain circumstances — as in the case of *Faraday* — the reinsured will not be able to rely upon any wider arguments relating to the commercial purpose of the clause.

The treatment of "follow the fortunes" clauses under English law also demonstrates the difference in approach between U.S. and English courts. The only significant reported case to deal with such a clause is *Hayter v. Nelson*, [1990] 2 Lloyd's Rep. 265, which considered a summary judgment application by retrocedent against its retrocessionaire. One of the points considered by Mr. Justice Savile was the effect of the inclusion of a follow the fortunes clause in the retrocession contract. He declined to accept the argument that the retrocessionaire had, based on various provisions in the contract, expressly or impliedly agreed to be bound by judgments given or awards made against the retrocedent. He did not seek guidance from the law on "follow the settlements" to reach that decision. Instead, he concluded that the proceedings should be stayed and referred to arbitration in accordance with the terms of the retrocession contract and, on the "follow the fortunes" issue, took comfort from the fact that a specialist arbitration tribunal would be better position placed to judge whether or not the retrocessionaire impliedly undertook to be bound by judgments or awards made against the reinsured. The outcome of the dispute is not known, in view of the confidential nature of arbitration proceedings.

A recent decision, *CGU International Insurance Plc & Ors v. AstraZeneca Insurance Co*., [2006] 1 C.L.C. 162, is consistent with this judicial approach. This was an appeal (to Mr. Justice Cresswell and then to the Court of Appeal) of a preliminary arbitral award regarding certain questions of law. In the arbitration, AstraZeneca Insurance Company sought indemnification from CGU in respect of a settlement made with its original insured (and parent company) AstraZeneca plc. The reinsurance contract contained a "follow the fortunes" clause, not a "follow the settlements" clause.

It appears, from the submissions made on behalf of the cedent in the appeal, that the arbitrators had taken the view that the clause made little sense if the reinsurer could otherwise avoid liability under English law. In principle, therefore, the clause bound CGU to follow (in that case) an Iowa judgment against AstraZeneca. Nonetheless, whilst confirming that the effect of the clause was not directly in issue on the appeal, Mr. Justice Cresswell noted, however, that despite the panel's comments, AstraZeneca had not contended, even before the panel, that a "follow the fortunes" clause on its own (without a "follow the settlements" clause in addition) was sufficient to establish liability in this instance.

This stands in contrast to the approach of the recent decision by U.S. courts, which would in all likelihood / *continued page 12*

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have held that the "follow the fortunes" clause applied to bind the reinsurer to the AstraZeneca settlement.[4]

Conclusions

The foregoing discussion has examined several notable 2006 U.S. and English court decisions on questions of interpreting "follow the fortunes" and "follow the settlements" clauses in reinsurance contracts. U.S. and English courts take distinct approaches in this regard, that can lead to similar facts and contract provisions generating opposing results in these two jurisdictions. It remains to be seen whether these trends will continue, potentially widening the gap between courts either side of the Atlantic on the "follow the fortunes/follow the settlements" doctrine in the coming years.

4 *See National Union*, 441 F. Supp.2d 646 (finding the reinsurer liable to indemnify the reassured for a settlement as a result of the "follow the fortunes" clause in the reinsurance agreement).

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