CANADA

Canadian Appellate Court Holds that Reinsureds Must Establish Legal Liability in the Absence of a Follow Settlements Clause

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In *Swiss Reinsurance Company v. Camarin Limited*, the British Columbia Court of Appeal clarified the test for proving liability under a reinsurance contract absent a follow the settlements clause. Where such a clause does not exist, the cedant faces a stricter test to recover from its reinsurer. In order for the cedant to recover from its reinsurer under the reinsurance policy, the Court held that the cedant had to prove that it's insured "would have" been liable in the underlying proceeding for damages covered by the underlying policy.

The Facts

Property damage claims arose out of roofing tile that allegedly failed in the 1990s, resulting in consolidated class proceedings in the U.S.A.. AIG insured the manufacturer of the roofing tiles under both primary and umbrella policies over several years. AIG's primary policies were not at issue. The focus of the case were the five AIG umbrella policies (the "original policies"). Camarin, the manufacturer's captive insurer, reinsured AIG for half of its limits respecting most of the original policies. Swiss Re reinsured Camarin for all of its liabilities to AIG (the "reinsurance policies").

In 2003, the proceedings, including a parallel coverage action, settled for US $70 million. AIG sought to recover approximately US $25 million from Camarin. Camarin accepted its obligation to indemnify. However, Swiss Re denied coverage and commenced the action. Swiss Re sought to rescind its reinsurance policies. It argued that there had been material non-disclosure: specifically, that the manufacturer had failed to report information relevant to its exposure. Camarin counterclaimed for judgment on the policies and sued its broker, AON, in the alternative, for negligence in failing to place the reinsurance policies with a follow the settlements clause.

The Trial

The trial judge dismissed Swiss Re's claim for rescission and granted judgment to Camarin on its counterclaim. He determined that Camarin was required to prove that the class action plaintiffs "would likely" have succeeded in their claim, and that the manufacturer "would likely" have succeeded in its coverage action. The trial judge also conditionally ruled that AON had been negligent. In the event that his judgment was reversed on appeal, the claim against AON would be made out. Both Swiss Re and AON appealed.

ABSENT A FOLLOW SETTLEMENTS CLAUSE, CEDANTS HAVE TO SUBSTANTIATE LIABILITY TO RECOVER FROM REINSURERS

The Appellate Decision

The Court of Appeal allowed the appeal and ordered a new trial. It held that the trial judge had mischaracterized material evidence regarding the non-disclosure issue.

The Court also held that the trial judge applied on the wrong test to determine a reinsurer's obligation to its cedant where the reinsurance policy in issue does not contain a follow the settlements clause. Camarin was required to show that the class action plaintiffs "would have" succeeded at trial, and that the manufacturer "would have" succeeded in its coverage action. The Court declined to make a final ruling on the merits, however, and remanded the parties back to trial due to evidentiary problems. In ordering a new trial, the Court also vacated the judgment against Aon and remanded the broker negligence claim back to trial. Leave to appeal to the Supreme Court of Canada was sought.

The Proper Test: "Would have" Not "Would likely"

As stated by the Court, a follow the settlements clause "relieves the reinsured of the responsibility of proving that there has been a loss". As such, it lowers the burden of proof on the cedant of proving liability under the reinsurance contract. It imposes a duty upon the reinsurer to follow the actions of the reinsured. The question before the Court of Appeal was to determine the proper test for establishing liability where there is no such clause.

The Court examined the operative language in the original policies. These policies responded to pay the insured for amounts it was "legally obligated to pay … as damages for liability imposed … by law" arising out of "property damage" caused by an "occurrence". The reinsurance policies were follow form and, therefore, incorporated the terms of the original policies. However, there was no clause in the reinsurance policies stating that Swiss Re was liable for settlements made by AIG under the original policies. In other words, there was no "follow the settlements" clause.

The Court canvassed UK case law on the issue and held that the trial judge applied the wrong test. The Court set out the principles to be applied to reinsurance policies in absence of a settlements clause. It held that liability under the policy had to be proven. It was not enough to prove that the settlement was reasonable. Camarin had to prove its legal obligation to Swiss Re in the same way that the manufacturer would have had to prove its loss in the underlying coverage action; that they were legally obligated to pay loss covered by the respective policies. The court held that the focus of the enquiry should be on the merits of the claim, not on the reasonableness of the underlying settlement, as it accepted that cedants may settle claims for reasons other than purely on the merits, such as bad faith concerns.

Commentary

This case underscores the stark contrast between a reinsurance policy that contains a follow the settlements clause and one that does not. In the former scenario, the reinsurer has made a business judgment that it will accept the settlements entered into by its cedant as valid, provided they are reasonable. In the latter case, the reinsured is forced to substantiate the underlying settlement. This means that the cedant must have sufficient evidence to prove that, on a balance of probabilities, it would have been liable to its insured. Absent a follow the settlements clause, the onus is on the cedant to substantiate liability under the reinsurance policy, not to prove that the settlement was reasonable. Furthermore, brokers may wish to address with cedants whether such clauses are required.

Both applications for leave to appeal to the Supreme Court of Canada have recently been dismissed.