YELDHAM PRICE O'BRIEN LUSK

EXCESS OF LOSS INSURANCE – WHO DECIDES HOW CLAIMS ARE ALLOCATED?

On 31 July 2013, the UK Supreme Court handed down judgment in *Teal Assurance Company Limited v WR Berkley Insurance Limited and another,* [1] a case which considers how a tower of insurance is exhausted by multiple claims against the insured due to the way in which those claims are allocated against the tower. This paper will examine the principles confirmed by the *Teal* decision and consider the likely implications for Australia.

The *Teal* decision

In broad terms, the issue in the case was whether a captive insurer was permitted to allocate claims in a way which maximised the cover available to the insured, because of a difference between the cover provided by the top excess layer and the lower layers.

The Supreme Court unanimously decided that the captive could not do this, upholding the decisions below of the Court of Appeal[2] and, before that, the High Court.[3] The Supreme Court's judgment was delivered by Lord Mance, with whom the President, Lord Neuberger, and Lords Clarke, Sumption and Toulson agreed.

The insured was Black and Veatch Corp (**BV**), an engineering, consulting and construction company incorporated in the USA with global operations, specialising in the energy, water, telecommunication, Federal and management consulting markets.

For the insurance year in question, which commenced on 1 November 2007, BV had a professional liability insurance programme consisting of the following tower:

- A deductible of USD 100,000 per claim (or USD 250,000 for remedial work under an endorsement).
- A self-insured retention of USD 10 million per occurrence and USD 20 million in the aggregate. BV insured part of this retention under a separate policy which was not relevant to the case.
- A primary layer of cover placed with a US insurer, Lexington Insurance Co, for USD 5 million excess of the deductible and the retention, with an aggregate limit of USD 20 million.
- Three excess layers placed with a captive insurer based in the Cayman Islands, Teal Assurance Co Ltd. Cover totalling USD 55 million was provided by these layers, as follows:
  - First excess layer: USD 5 million any one claim and in the aggregate, excess of the primary layer (ie. excess USD 15 million).
  - Second excess layer: USD 30 million any one claim and in the aggregate, excess of USD 20 million.
  - Third excess layer: USD 20 million any one claim and in the aggregate, excess of USD 50 million.

  The captive reinsured the risks under these three layers with various reinsurers.
- A top layer insured by the captive under a 'top and drop' policy, which applied in excess of the primary and excess layers and provided cover of GBP 10 million or equivalent.

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[1] [2013] UKSC 57

[2] [2011] EWCA Civ 1570

[3] [2011] EWHC 91 (Comm)

> The captive reinsured this layer with two underwriters, WR Berkley Insurance (Europe) Ltd and Aspen Insurance UK Ltd for 50% each.

The 'top and drop' policy excluded cover for claims emanating from or brought in the USA and Canada. The primary and lower excess layers, however, did provide cover for US and Canadian claims.

As the name of the case suggests, the dispute was between the captive and the reinsurers of the 'top and drop' layer. The dispute arose because BV notified its insurers of multiple claims during that policy year, some emanating from or brought in the USA or Canada, others not.

BV notified 27 claims during the relevant policy year, of which four had a value in excess of USD 1 million. Two of those four were US or Canadian claims, with values put by BV (including incurred costs) at approximately USD 10.5 million and over USD 200 million respectively. The other two of the four had values put by BV (including incurred costs) at approximately USD 33.9 million and just over USD 8 million, after deductibles, respectively.

Given that these four claims had the potential to exhaust the tower, there was a risk for BV that if the US/Canadian claims impacted the tower in the 'top and drop' layer, they would not be covered. It was plainly in BV's interests that the US/Canadian claims impact the tower in the lower layers, where cover was available. The captive, being an associate of BV, wanted to meet the two non-US/Canadian claims from the top layer, irrespective of the dates of their ascertainment against BV, rather than exhausting the lower layers on those claims. The reinsurers of the top layer objected to this.

Principles

In issue was the order in which the claims were ascertained against BV, and the relevance of that order in circumstances where the captive wanted to treat the claims out of order.

The general principle in the context of third party liability insurance, as formulated in *Cox v Bankside Members Agency Ltd,*[4] is as follows:

> 'No obligation on the part of the insurer arises until the liability of the assured to a third party is established by judgment, arbitration award or settlement.'

Later claims, if established, do not result in further liability on the part of the insurer in excess of coverage limits. It follows that claims have priority in relation to the available insurance in the order in which liability is established by judgment, award or settlement. This has been described as the 'dash for cash' rule of priority, or the 'first past the post' approach.

In *Teal*, however, the captive challenged the proposition that the ascertainment of a claim against the insured exhausts the available cover pro tanto. The captive accepted that, under a claims made liability policy, an insurer's liability arises typically as and when loss within the scope of the policy is ascertained against the insured. However, the captive argued that it is only when the claim is actually met by the insurer that the cover is exhausted. Until that occurs, if there is a second claim notified, the insured is free to claim and the insurer is liable to pay the later claim, rather than the earlier, ascertained claim.

The Supreme Court did not accept this argument, pointing out that where insurance has a limit, it makes no sense to speak of the insured having causes of action or recoverable claims which together would exceed that limit. If the limit is, say, $10 million, and there are two third party claims successively ascertained at $7.5 million each, the insured does not have two causes of action against its insurer for $7.5 million each. The insured has two causes of action, but the second is only for $2.5 million. The insurer is not obliged (and is not at liberty) to pay the full amount of the second claim.

Analysis of the policy terms

The Court then considered whether the terms of the policies in question were consistent with the general principle or whether they would lead to a different result.

Each of the three lower excess layer policies contained the following set of clauses:

> '1. Liability to pay under this Policy shall not attach unless and until the Underwriters of the Underlying Policy/ies shall have paid or have admitted liability or have been held liable to pay, the full amount of their indemnity inclusive of costs and expenses.'

[4] [1995] 2 Lloyd's Rep 437

2. It is a condition of this Policy that the Underlying Policy/ies shall be maintained in full effect during the currency of this Policy except for any reduction of the aggregate limits contained therein solely by payment of claims or of legal costs and expenses incurred in defence or settlement of such claims.

3. If by reason of the payment of any claim or claims or legal costs and expenses by Underwriters of the Underlying Policy(ies) during the period of this Insurance, the amount of the indemnity provided by such Underlying Policy/ies is:-

   (a) Partially reduced, then this Policy shall apply in excess of the reduced amount of the Underlying Policy/ies for the remainder of the period of insurance; and

   (b) Totally exhausted, then this Policy shall continue in force as Underlying Policy until expiry hereof.'

Once the primary layer was used up, the first excess layer would be engaged, and so on up the tower until the top layer was engaged.

The captive argued that its liability under the top layer policy was conditioned by the order in which the underlying layers pay, admit or are held to have liability, meaning the captive in its capacity as underlying insurer could shape its own liability as top layer insurer. In simple terms, the captive wanted to choose to pay or admit the US/Canadian claims under the lower layers, leaving the non-US/Canadian claims to be covered by the more restrictive top layer.

The Supreme Court rejected this argument and made a number of observations about it. Firstly, it treats a clause intended to define *when* liability arises as affecting the claims *in respect of which* liability arises. Secondly, the captive's analysis looks at the picture from the top down, not from the bottom up, which is how claims in fact impact the programme. The primary layer insurer becomes liable to pay claims in the order in which BV incurs ascertained expenses or third party liability (through judgment, award or settlement). The only claims which it can pay or admit are those where ascertained expenses or third party liability have been incurred. To the extent that the primary layer insurer has paid or admitted or been held liable to pay claims, all that the captive as excess layer insurer can do is pay any balance of those claims remaining and then any later ascertained expenses or liability BV may have incurred. This is consistent with the 'drop down' operation of the excess layers. The captive cannot make payments other than, or in a different order than, those for which it will in due course become underlying insurer when its excess insurance drops down to become the underlying policy.

Commerciality

Although not necessary to the decision, the Supreme Court considered some issues of commerciality which reinforced the conclusion.

The Court acknowledged that, on its analysis, there was scope for haphazard results and also for some degree of control by an insured or primary insurer in the timing of ascertainment of liabilities.

On the other hand, the situation being considered by the Court was the product of the excess layers being insured through a captive insurer, which was attempting to achieve a particular outcome for the benefit of its associate, BV. If it had been an independent insurer determined to avoid as much liability to BV as possible, BV would no doubt object to the insurer adjusting the order of payment of claims to ensure that US/Canadian claims reached the top layer. The Court could not reconcile the notion of that freedom of choice with the basic philosophy that insurance covers risks lying outside an insured's own deliberate control.

Consequences

Teal confirms the general principle that claims impact the available insurance in the order in which liability is established against the insured by judgment, award or settlement. It is not open to the insured or insurer to alter that order to achieve a particular outcome. This also applies to defence costs as they are incurred.

There are, however, ways in which the outcome might be manipulated.

An insured might choose not to seek cover for a particular claim, either by refraining from notifying it, or by abandoning or withdrawing a notified claim. This would obviously be a fairly drastic solution for the insured and not one which would necessarily be expected if the aim is to maximise cover, but there may conceivably be circumstances in which an insured might choose not to seek cover in order to preserve that cover for another claim which might, for

example, be covered on more favourable terms for the insured, or where the consequences of having no cover would be relatively worse for the insured.

Alternatively, an insured (or an insurer for that matter) might conduct the defence of a claim and any settlement negotiations in a way which either hastens or delays its progress to judgment or settlement, to achieve the desired order of ascertainment.

There may be provisions in the policy which permit an excess insurer to object to the manipulation of the outcome by the insured or lower layer insurers.

Further, in Australia, such manipulation might give rise to good faith issues, depending on what is done and with what intent.

Implications for Australia

That brings us to the issue of whether *Teal* is good law in Australia. In our opinion, the principles enunciated by the UK Supreme Court, and the Court's application of them to the particular policy terms, are sound. We think *Teal* would be likely to be followed by Australian courts, unless there is anything in Australian law which changes the outcome, and potentially there is, at least in some Australian jurisdictions.

New South Wales, the Australian Capital Territory and the Northern Territory have legislation which creates a statutory charge over insurance moneys in favour of claimants. The best-known for our purposes is s 6 of the *Law Reform (Miscellaneous Provisions) Act* 1946 (NSW).[5]

The Australian provisions are similar to those in New Zealand from which they were adopted, which in their current form are found in s 9 of the *Law Reform Act* 1936 (NZ). Originally, these provisions were introduced in New Zealand in the context of workers' compensation and motor vehicle insurance legislation. The legislature's intention in adopting them, at least in NSW, was to prevent a situation where liability is established against an insured person and the insurer pays a sum to the insured person, who then disappears or appropriates the funds without paying them to the claimant, or alternatively a situation where the insurer and insured enter into a collusive arrangement to the claimant's detriment.

This is achieved by creating a new relationship between claimant and insurer, to the benefit of the claimant. In broad terms, a charge is created by statute, which attaches to the insurance moneys and is enforceable by the claimant directly against the insurer. The charge comes into existence on the happening of the event giving rise to the claim, not when liability is established against the insured. The legislation also creates rights of priority over the insurance moneys, by reference to the order of the dates of the events out of which each charge arose.

Depending on how the charge is held to operate, there is an obvious potential for it to alter the outcome in *Teal* if an insurer is on notice of a charge attaching to insurance moneys, effectively binding those moneys, before any claims have been ascertained.

Chubb v Moore and *Bridgecorp*

The NZ and NSW provisions have been considered in recent well-publicised cases: the *Bridgecorp* series of decisions in New Zealand, and the decision of the NSW Court of Appeal in *Chubb Insurance Company of Australia Limited v Moore*.[6] For the time being, the two jurisdictions have taken opposite approaches, although an application for special leave to appeal to the High Court of Australia in *Chubb* is pending.[7]

The two cases considered in particular the tension between the existence of a charge for a claim exceeding the policy limit and the advancement by the insurer of defence costs, but it is not the aim of this paper to examine that issue.

In both cases, it was acknowledged that the relevant statutory provisions also give rise to questions of priority between competing or rival claims. Where a statutory charge is created, does it override the general principle that no obligation arises on the part of the insurer until

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[5] The ACT provision is s 206 of the *Civil Law (Wrongs) Act* 2002. The NT provisions are ss 26-28 of the *Law Reform (Miscellaneous Provisions) Act*.

[6] [2013] NSWCA 212

[7] At the time of preparing this paper, the special leave application was listed for hearing on 14 March 2014. On that date, it was stood over and it remains pending.

the insured's liability is established by judgment, arbitration award or settlement? Could the existence of a statutory charge for a sufficiently large sum, once the insurer has actual notice of it, prevent the insurer from making payments in respect of other claims arising from events which occurred later in time than the events giving rise to the charged claim, irrespective of whether those other claims proceed to judgment, award or settlement before the charged claim?

The NSW Court of Appeal held in *Chubb* that the charge is a floating charge, in respect of insurance moneys that may become payable and do in fact become payable at a later date. The charge does not become fixed (or attached) until insurance moneys have become payable in respect of the liability.

In the context of competing claims, the Court (per Emmett JA and Ball J, with whom Bathurst CJ, Beazley P and Macfarlan JA agreed) said the following:[8]

> 'Where the indemnity concerns an obligation to satisfy a judgment, award or settlement, the right to the indemnity arises at the time when the liability is established by that judgment, award or settlement ... At that time, the insured is entitled to sue on the indemnity and, subject to the exhaustion of the maximum liability under the relevant contract of insurance, is entitled to recover the amount of the judgment, award or settlement. The fact that other claims have been, or may be brought, against the insured, or any other insured indemnified by the same contract of insurance, does not alter the first insured's right to indemnity in respect of the liability that has been determined.
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> If s 6 caught all moneys available at the time when the charge arises, and s 6(1) applied to a second claim, an insurer could not safely pay the first ascertained claim if the second claim might exceed the amount of the limit that would then remain, unless it could be satisfied that the first ascertained claim has priority under s 6(3). Again, on that approach, the effect of s 6 would be, by a side wind, to alter the rights of the contracting parties. The insurer would be entitled to refuse to pay a claim that it was obliged by the terms of the contract of insurance to pay, because it would run the risk of having to pay more than the maximum amount it contracted to pay.
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> ...
>
> It is true that, if priority is given only in respect of moneys that have become payable as a result of a judgment, award or settlement, the circumstances in which there may be competing claims to that sum of money will be rare. Generally, competing claims will only arise where a judgment is obtained in favour of a number of claimants whose claims arise out of the same or similar facts.'

Chubb decided, in other words, that s 6 permits third party claims to be paid in the order in which a judgment, award or settlement is achieved. In practical terms, it preserves the 'dash for cash' rule of priority.

The Court in *Chubb* also relevantly held that:

- although s 6 applies to claims made policies, it does not create a charge based on a claim arising from events occurring before the commencement of the policy (which is significant because this is the frequently the case with professional indemnity claims and other claims notified under claims-made policies); and
- s 6 should be treated as applying to all claims brought in a court of New South Wales, and as not applying to a claim that is not brought in a court of New South Wales.

Accordingly, if the decision in *Chubb* stands, it is likely that the outcome in *Teal* would not be affected at all by s 6 (even in claims brought in a court of New South Wales).

The NSW Court of Appeal in *Chubb* had regard to and accorded with the decision of the New Zealand Court of Appeal in *Bridgecorp*, which then stood.[9] Subsequently, on 23 December 2013, the New Zealand Supreme Court has delivered its decision in the *Bridgecorp* matter, overturning the Court of Appeal's decision and reversing the position in New Zealand.[10] This has caused well-publicised problems for insurers and insureds in relation to the advancement of defence costs, but it also gives rise to tensions between competing claims.

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[8] At [126]-[130]

[9] *Steigrad v BFSL 2007 Ltd* [2013] 2 NZLR 100

[10] *BFSL 2007 Limited & Ors (in liquidation) v Steigrad* [2013] NZSC 156

The New Zealand Supreme Court held that a charge under s 9 arises at the time of the event giving rise to the liability, and that it secures whatever the full amount of the liability (if any) to the third party ultimately turns out to be. On this analysis, where there are competing claims, s 9 displaces the common law rule of priority based on the establishment of liability by judgment, award or settlement.

Although this was a 3/2 majority decision (the majority being Elias CJ, Glazebrook and Anderson JJ), all five judges disagreed with *Chubb* on the issue of competing claims. The insurers in *Bridgecorp* appear to have effectively conceded that s 9 affects the order of priority and overrides the contract with regard to competing claims. The minority (McGrath and Gault JJ) stated:

> 'The priority of a charge is preserved from the time of the event giving rise to liability. To this extent, we disagree with the decision in *Chubb* that s 9(3) allows third party claims to be paid in the order in which judgment or settlement is achieved. We understand the majority to be of the same view.'

From a policy perspective, there is a clear difference in approach. The NSW Court of Appeal in *Chubb* placed weight on the rights of the parties to the insurance contract, and was clearly uncomfortable with the notion that the legislation would operate to alter that contractual relationship so drastically. The majority in the New Zealand Supreme Court, on the other hand, placed weight on the notion that the legislation was intended to benefit claimants and that it places the risk of observing the statutory charge on the insurer.

The New Zealand Supreme Court is the final avenue of appeal. Unless the legislature intervenes, *Bridgecorp* is now settled law in New Zealand.

It remains to be seen whether the position in NSW will continue to differ from that in New Zealand. If special leave is granted in *Chubb*, the High Court of Australia will consider the matter without being bound by the authority which bound the NSW Court of Appeal.

If *Chubb* is overturned, there are likely to be calls for legislative intervention. Even if that occurs, it is possible that such intervention might address the issue of defence costs, but not priority between competing claims.

For the time being, we consider that the outcome in *Teal* is good law and is likely to followed in Australia, including in NSW, the ACT and NT.

March 2014

This article was prepared by Dougal Langusch, Senior Associate, and Paul O'Brien, Director. Dougal Langusch can be contacted on (02) 9231 7061 or at dlangusch@ypol.com.au and Paul O'Brien can be contacted on (02) 9231 7020 or at pobrien@ypol.com.au.

LEVEL 2, 39 MARTIN PLACE
SYDNEY NSW 2000
DX 162 SYDNEY
T: +61 2 9231 7000
F: +61 2 9231 7005
WWW.YPOL.COM.AU

YPOL PTY LTD TRADING AS
YELDHAM PRICE O'BRIEN LUSK
ACN 109 710 698

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