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FUNCTIONS, DEFINITIONS, AND TYPES OF REINSURANCE

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A. Historical Background

1.01 The earliest recorded reinsurance arrangement[1] appears to have been effected in the fourteenth century when an underwriter reinsured the hazardous part of a marine voyage from Genoa to Sluys. Professional reinsurers, however, did not emerge until the nineteenth century, some two centuries after the first professional insurers were founded. The first of these was the Cologne Reinsurance Company, which was formed in 1846 after a catastrophic fire in Hamburg had led to losses well beyond the reserves of the insurers—the Hamburg Fire Fund.[2]

1.02 By the middle of the nineteenth century London had become firmly established as the central market for marine insurance. This was in part because the conducting

[1] According to CE Golding, *The Law and Practice of Reinsurance* (5th edn, London: Witherby & Co Ltd, 1987).

[2] Cologne Reinsurance Company was followed relatively swiftly by the formation of Swiss Re in 1863 and Munich Re in 1880.

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of reinsurance business was prohibited by statute[3] in England until as late as 1864,[4] and this had forced direct insurers to join together into syndicates in order to cover risks beyond their individual financial means, which in turn had led to the availability of considerable insurance capacity in the London market. It is not entirely clear why reinsurance was rendered illegal in the middle of the eighteenth century. Lord Mansfield speculated that the reason for the prohibition was that reinsurance was viewed as gambling at a time when gambling was clearly a widespread social problem in England.[5] Park J[6] ascribed the prohibition to the fact that reinsurance was being abused by insurers to relieve themselves of risks which they had 'incautiously undertaken', stating:

> [T]he law of England . . . permitted the underwriters upon policies to insure themselves against those risks for which they had inadvertently engaged to indemnify the insured; or where perhaps they had involved themselves to a greater amount than their ability would enable them to discharge. Although such a contract seems perfectly fair and reasonable in itself, and might be productive of very beneficial consequences to those concerned in this important branch of trade; yet, like many other useful institutions, it was so much abused, and turned to purposes so pernicious to a commercial nation, and so destructive of those very benefits it was originally intended to promote and encourage, that the Legislature was at last obliged to interpose, and by a positive law to cut off all opportunity of practising those frauds in future, which were become thus glaring and enormous.[7]

1.03 Lord Hoffmann explained in *Charter Reinsurance Co Ltd v Fagan*:[8]

> Contracts of reinsurance were unlawful until 1864. Such a contract [of reinsurance] is not an insurance of the primary insurer's potential liability or disbursement. It is an independent contract between reinsured and reinsurer in which the subject matter of the insurance is the same as that of the primary insurance, that is to say, the risk to the ship or goods or whatever might be insured. The difference lies in the nature of the insurable interest, which in the case of the primary insurer, arises from his liability under the original policy.

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[3] Reinsurance was rendered illegal by the Marine Insurance Act 1745 (19 Geo 2, c 37). Note that s 4 of the Act provided that 'reinsurance' was prohibited 'unless the insurer should be insolvent, become a bankrupt, or die; in either of which cases the insurer, his executors, administrators, or assigns were permitted to provide reinsurance to the amount of the sum insured, provided it was expressed in the policy to be reinsurance'. It should be recognized that this was not a limited exception to the provision of 'reinsurance' as understood by that word today; rather it referred to the provision of a new policy of insurance being effected with a new insurer.

[4] In 1864 the Revenue No 2 Act (27 & 28 Vict, c 56) effectively rendered reinsurance lawful.

[5] 1745 also saw the enactment of legislation to outlaw the playing of roulette (also known as 'roly-poly' at that time), and the first half of the eighteenth century saw a flurry of legislative activity to prevent gambling.

[6] In his book *A System of the Law of Marine Insurances* (8th edn, 1842, reprinted 1987: Professional Books) 596–597.

[7] Hobhouse J cited this passage with apparent approval in *Phoenix General Insurance Co of Greece SA v Halvanon Insurance Co Ltd* [1985] 2 Lloyd's Rep 599, 611.

[8] [1997] AC 313, 392.

1.04 When the prohibition was lifted, the discriminating and capable reinsurer flourished. In 1911 Scrutton J, in *Glasgow Assurance Corp v Symondson*,[9] stated:

> When one finds, as one frequently does at Lloyd's, A agreeing to reinsure B against every risk insured by B at a premium based on a percentage of the premiums received by B, and always therefore smaller, one is naturally inclined to think that B has a temptation to accept every risk, however bad, and pass it on to A at a smaller premium, and therefore at a certain profit such system is absurd and cannot work. But as Bowen LJ said in *Sanders v McLean*, anyone who attempts to follow and understand the law of merchants will soon find himself lost if he begins by assuming that merchants conduct their business on the basis of attempting to insure themselves against fraudulent dealing. Credit, not mistrust, is the basis of commercial dealings, and mercantile genius consists principally in knowing whom to trust and with whom to deal.

1.05 The turmoil created by two world wars saw England and the United States coming to the forefront of international reinsurance business, usurping the dominant position that had previously been held by German reinsurers. The City of London became the leading reinsurance market in the world, using both companies and Lloyd's 'names' to provide unparalleled technical expertise and market capacity. It remains a major reinsurance centre today, working in partnership particularly with companies based in the United States, Bermuda, and Germany.[10]

1.06 As Lord Collins commented in *Wasa International Insurance Co v Lexington Insurance Co*:[11]

> [A]fter banking, insurance is the United Kingdom's largest invisible export, of which reinsurance forms a large part, and amounted to at least £1.2bn in 2007.

B. The Functions of Reinsurance

1.07 Lord Mance has neatly encapsulated the basic function of reinsurance on a number of occasions; first as follows:

> In insurance, the matching of exposure and protection to assure both solvency and profitability is absolutely fundamental. Reinsurance—of whatever type—is a principal means to this end.[12]

1.08 Summarizing the way in which reinsurance works in *Wasa International Insurance Co v Lexington Insurance Co* he said:[13]

> Reinsurance is a settled business conducted worldwide by experts, often (even if past experience indicates not invariably) possessing very considerable legal

[9] (1911) 16 Com Cas 109, 110–111.

[10] For a more detailed history of reinsurance see Golding, n 1.

[11] [2010] 1 AC 180; [2009] 2 Lloyd's Rep 508, para 55 citing the Office for National Statistics, *United Kingdom Balance of Payments: The Pink Book 2008*, 52.

[12] Per Mance J as he then was in *Charter Reinsurance Co Ltd v Fagan* [1997] AC 313, 343.

[13] [2010] 1 AC 180; [2009] 2 Lloyd's Rep 508, para 33.

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knowledge and expertise. The well-recognised analysis which neither side gainsaid before your Lordships is that a reinsurance such as the present is an independent contract, under which the subject matter reinsured is the original subject matter. The insurable interest which entitles the insurer to reinsure in respect of that subject matter is the insurer's exposure under the original insurance. The principle of indemnity limits any recovery from reinsurers to the amount paid in respect of that insurable interest... Reinsurance business is classified in accordance with this well-settled analysis for regulatory purposes: Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544). Reinsurance slips are underwritten identifying the subject matter insured (here, against the headings 'Interest' and 'Situated') as the original insured's property, rather than the insurer's exposure or liability under the original insurance... There is no basis or justification for courts to throw unnecessarily into doubt an accepted analysis with business significance.

1.09 The broad purpose of reinsurance is for the direct insurer to be covered in respect of his liability under an original insurance policy, pursuant to which the original insured is entitled to recover from him.[14] The direct insurer gives protection to individuals and businesses against the uncertain risks associated with life and commerce. The reinsurer takes a share of those risks (and a share of the premium), thus spreading the consequences of the losses should a risk event take place.[15] Furthermore, an insurer cannot predict with certainty which part of the business that it writes will result in profits and which part in losses each year, and reinsurance enables the insurer to smooth the peaks and troughs of his business results.

1.10 The functions of reinsurance, however, are not only protective—there are significant business advantages to be gained by an insurer that can obtain reinsurance. Primarily reinsurance provides capacity to an insurer, thereby enabling the insurer to insure a volume, type or size of risk that it would not be able to cover in the absence of reinsurance. In effect, the reinsurer enlarges the direct insurer's underwriting capacity by accepting a share of the risks and by providing part of the necessary reserves for losses.

1.11 Reinsurance also increases the capital available to the direct insurer which would otherwise be earmarked to cover potential losses. This is of some significance to the conducting of reinsurance business both in England and elsewhere. A yardstick commonly used by regulatory bodies[16] in controlling insurance companies is the margin of their solvency—defined under the Insurance Companies

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[14] Per Potter LJ *in Skandia International Corp v NRG Victory Reinsurance Ltd* [1998] Lloyd's Rep IR 439, 459.

[15] One consequence of the drive to spread risks as widely as possible is that reinsurance often involves international transactions so that parts of each large risk are taken by the major reinsurance markets across the globe. This not only permits risks to be spread more effectively, but also provides international experience.

[16] The insurance industry in England is now regulated by the Financial Services Authority (pursuant to the Financial Services and Markets Act 2000). The FSA has four objectives under the Act: maintaining market confidence; promoting public understanding of the financial system; appropriate protection for consumers; and fighting financial crime.

Act 1982[17] as the excess of the value of its assets over the amount of its liabilities. Regulatory authorities will frequently have minimum margins or ratios below which they will not allow insurers to operate.[18] Reinsurance, therefore, can strengthen the solvency ratio of the direct insurer.

C. Parties to a Reinsurance Contract

1.12 The parties to a reinsurance contract can be referred to by different titles depending on the context. Essentially a reinsurer agrees to provide cover to a reinsured by entering into a contract of reinsurance. However the reinsured will itself be an insurer and the reinsurer will often itself be reinsured under a further contract of retrocession. The terms insured and reinsured are often used interchangeably in the market with assured and reassured.[19] Where the reinsurer is reinsured under a contract of retrocession it is referred to as a 'retrocedant', whilst its reinsurer is a 'retrocessionaire'.

1.13 The parties to the insurance and reinsurance contracts are necessarily different and the insurance and reinsurance are separate contracts. This was explored when a reinsurer, Meadows, claimed not only a declaration as to the validity of its contract of reinsurance but also a declaration as to the validity of the underlying contract of insurance, entered into between its reinsured, I.C.I. and the underlying insured, I.C.B.[20] Neill LJ dismissed the second claim for a declaration pointing out that:

> These two parties have no rights or obligations against or to each other; they are not in a contractual relationship. Although there is of course a connection between the contract of insurance on the one hand and of re-insurance on the other, Meadows' rights are in no way involved in the existing dispute between I.C.I. and I.C.B. Whether I.C.I. has to pay I.C.B. depends upon the terms and circumstances of the insurance contract between them and, if relevant, any non-disclosure or misrepresentation that occurred between them. In so far as Meadows is concerned, any liability on their part will depend upon the contract of re-insurance and the factual situation which existed between them when this was entered into.

1.14 In *Markel Capital Ltd v Gothaer Allgemeine Versicherung*[21] the Court considered the definition of 'Reinsured' in the slip of a reinsurance of a Directors' and Officers' cover. The defendant's agent was listed as the reinsured, but the Court noted that

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[17] s 32.

[18] This approach was put on a statutory footing in England in 1946. Previously regulation under the Assurance Companies Act 1909 required insurers (and reinsurers after the decision of the House of Lords in *Forsikringsaktieselskapet National of Copenhagen v Attorney General* [1925] AC 639) to lodge deposits with the High Court in order to conduct business.

[19] The term 'reassured' is particularly used in relation to life insurance and marine reinsurance. When someone is a party to a reinsurance treaty, they are commonly referred to as a 'cedant' as there is a cession of part of the risk (and premium) to a reinsurer. However for the purposes of simplicity the word reinsured is preferred in this book.

[20] *The Meadows Insurance Co Ltd and The Insurance Corporation of Ireland plc v International Commercial Bank plc* [1989] 2 Lloyd's Rep 298.

[21] [2009] Lloyd's Rep IR 433.

it was not unnatural for a slip contract to specify that the reinsureds were entering into it through an agent. The Court took into account all the uses of the word 'reinsured' in the slip contract, including the fact that the agreement was to reinsure the 'reinsured's' interest, and the interest was to indemnify 'the Reinsured'. It was the reinsureds and not their agents who were to be indemnified.

D. Fronting

1.15 The availability of reinsurance can enable smaller insurers notionally to accept risks that are considerably beyond their capacity, and perhaps expertise, by 'fronting' the insurance, whilst reinsuring the entirety, or the vast majority, of the risk to a reinsurer that specializes in that type of business. The use of fronting is also common in circumstances where the reinsurer is not permitted to conduct direct insurance business in a certain country (or state) and therefore has to find a local insurer notionally to insure the risk. The local insurer can issue a direct policy and pass all the risk (and premium)[22] to the reinsurer which, in effect underwrites the risk. The use of 'fronting' can result in a reversal of the traditional course of business, with reinsurers agreeing to reinsure the entirety of a risk with an individual or business and then having to find an insurance company prepared to act as the fronting insurer.[23] Alternatively the local insurer may retain some of the risk and the reinsurer will take account of the amount of risk retained by the reinsured in considering whether to accept the cession and on what terms.

1.16 The availability of reinsurance has facilitated the development of 'captive' insurance companies in places such as Bermuda and the Isle of Man. The reinsurance of 'captive' insurance companies is often in substance a form of fronting arrangement. Rather than placing its insurance cover in the insurance market, a group of companies may set up an offshore 'captive' insurance company, the only purpose of which is to provide insurance cover to the group. All or a substantial part of the risk will then be reinsured by those who would otherwise have been the insurers under a comprehensive programme of reinsurance protection which controls and limits the net exposure of the captive.

1.17 Where a reinsurer accepts the risk with the reinsured acting as the front, there ought to be a claims control clause in the reinsurance so that the reinsurer can control the investigation and adjustment of the underlying claim.[24] This can lead to tension when a local insurer fronting a local risk is commercially inclined to pay

[22] Retaining a commission for the cession of the risk.

[23] See *Commonwealth Insurance Co of Vancouver v Groupe Sprinks SA* [1983] 1 Lloyd's Rep 67 for an early reported example of such an arrangement.

[24] See paras 5.07 et seq.

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out on the claim in circumstances where the reinsurer takes a very different view about the agreement or adjustment of the claim.

E. Retrocession

1.18 For the same reasons that insurers need reinsurance, prudent reinsurers will also use the reinsurance market in order to cede part of their potential exposure to other reinsurers. This is known as 'retrocession', with the reinsurer of the reinsurer known as the 'retrocessionaire'. Where an insurer insures part of his liability, that is reinsurance. However, where a reinsurer insures part of his liability, that is a retrocession.[25] In simple terms, then, a retrocession agreement is a form of insurance contract under which a reinsurer insures the liability of another reinsurer in respect of reinsurances that the latter has entered into.[26]

1.19 Retrocession arrangements may also involve the use of fronting. Fronting may be used where the insurer or reinsurer is not confident in the solvency or security of the proposed reinsurer or retrocessionaire and a fronting company, in whom the insurer or reinsurer has confidence, is interposed to front the cover, with the fronting company then retroceding the cover to the proposed ultimate reinsurer. The insurer/reinsurer can then rely on the solvency and security of the fronting reinsurer, rather than that of the ultimate reinsurer, see *Wace v Pan Atlantic Group Inc*.[27]

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F. A Legal Definition of Reinsurance

1.20 Reinsurance eludes a simple concrete legal definition. This is due in large measure to the fact that reinsurance is primarily a product that exists in, and has been responsive to, a marketplace and which has therefore spawned numerous and varied types; it is not a monolithic whole.

1.21 An early definition of reinsurance was furnished by Lord Mansfield in *Delver v Barnes*.[28] He said this:

> This contract . . . does not fully amount to a reassurance, which consists of [1] a new assurance, effected by a new policy, [2] on the same risk which was before insured,

[25] Lloyd J in *Commonwealth Insurance Co of Vancouver v Groupe Sprinks* [1983] 1 Lloyd's Rep 67, 87 said: 'It may well be that a retrocession agreement is sometimes described as reinsurance; in so far as it is a reinsurance of a reinsurer, the use of the word is accurate. But I have never heard a reinsurance of the original insurer described as a retrocession. I had thought the meaning of the word was well understood.'

[26] Per Hirst J in *Transcontinental Underwriting Agency SRL v Grand Union Insurance Co Ltd* [1987] 2 Lloyd's Rep 409.

[27] [1981] 2 Lloyd's Rep 339, 344. See also *Sirius International Insurance Corp v FAI General Insurance Co Ltd* [2004] Lloyd's Rep IR 47 in which Sirius fronted reinsurance for FAI because the reinsured was not happy with the security of FAI as reinsurer.

[28] (1807) 1 Taunt 48.

> [3] in order to indemnify the underwriters from their previous subscription' and [4] both policies are in existence at the same time [numbers added].

1.22 The definition provides a useful heuristic. However, it is not all-encompassing. For example, it does not grapple with the modern practice of reinsurance being arranged before the insurance policy is entered into, either through fronting or where, for example,[29] a risk is so great or of such a type that underwriters will only subscribe if they are also offered reinsurance. In such circumstances, brokers will often first find reinsurers who are prepared to reinsure the risk (and offer to do so) before they obtain subscriptions from direct insurers.[30] It also fails to address certain types of non-facultative reinsurance (for example general or whole account excess of loss reinsurance) where what is reinsured is the risk that all or a defined part of the reinsured's account will suffer an aggregate loss in excess of a specific amount or a catastrophic loss in excess of a specific amount.

1.23 In *Toomey v Eagle Star Insurance Co Ltd*[31] Hobhouse LJ stated that the word 'reinsurance' had been used very loosely and often simply to describe a contract of insurance which had been placed by or for the benefit of the insurer. He suggested that reinsurance is not 'a mere liability insurance'; rather, reinsurance properly defined 'is the insurance of an insurable interest in the subject matter of an original insurance and that the principles of subrogation apply'.[32] Hobhouse LJ approved the definition enunciated by Buckley LJ in *British Dominion General Insurance Co v Duder*[33] that:

> A contract of insurance and a contract of re-insurance are independent of each other. But a contract of re-insurance is a contract which insures the thing originally insured, namely, [in this case] the ship. The re-insurer has an insurable interest in the ship by virtue of his original contract of insurance. The thing insured, however, is the ship and not the interest of the re-insurer in the ship by reason of his contract of insurance upon the ship.

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[29] See, eg, *General Accident Fire and Life Assurance Corp v Tanter* (The Zephyr) [1984] 1 Lloyd's Rep 58; [1985] 2 Lloyd's Rep 529, CA; *Commonwealth Insurance Co of Vancouver v Groupe Sprinks SA* [1983] 1 Lloyd's Rep 67; *CNA International Reinsurance Co Ltd v Companhia de Seguros Tranquilidade SA* [1999] Lloyd's Rep IR 289.

[30] Insofar as a contract is concluded at this stage it is not a bilateral contract of insurance; rather it is akin to a unilateral contract by which the reinsurer offers to provide reinsurance in the future if required; the reinsurer effectively offers to reinsure any underwriter falling within the class or category described in the slip, whether or not the broker has at that time obtained any subscription to the original line or an order for reinsurance. The reinsurance contract, properly understood, is only made when the broker conveys the reinsurer's offer to the underwriter and the underwriter accepts both the risk and the reinsurance. The insurance and the reinsurance are, therefore, effected simultaneously.

[31] [1994] 1 Lloyd's Rep 516.

[32] [1994] 1 Lloyd's Rep 516, 523.

[33] [1915] 2 KB 394, 400. This case effectively settled the issue as to whether a contract of reinsurance was a contract of indemnity that had troubled the courts for some time in the late nineteenth and early twentieth centuries, see *Uzielli & Co v Boston Marine Insurance Co* [1884] 25 KB 11; *Nelson v Empress Assurance Corp Ltd* [1905] 2 KB 281.

1.24 Hobhouse LJ also cited with approval the statement of Viscount Cave LC in *Forsikringsaktieselskapet National of Copenhagen v Attorney General*[34] that:

> The reinsuring party insures the original insuring party against the original loss, the insurance interest of the original insuring party being constituted by its policy given to the original assured.

1.25 In *Toomey* a syndicate at Lloyd's had reinsured to close the totality of certain accounts to Eagle Star. Hobhouse J took the view, on the basis of his rather narrow definition, that this was not reinsurance; rather it was a 100% stop-loss policy,[35] covering the 'run-off' of liabilities on the relevant accounts, and was effectively in the nature of an original insurance rather than reinsurance, properly so called.

1.26 The reinsurance market would doubtless view stop-loss insurance as a species of reinsurance and it is difficult to understand why such an arrangement should be excluded from a definition of reinsurance, particularly against a background in which Hobhouse J had previously stated that, as a matter of reinsurance law, there was no inconsistency between the idea of reinsurance and a nil retention by the reinsured.[36] The courts should strive to ensure that their approach to a definition of reinsurance is consonant with the market's understanding and practice. In numerous cases, they have done so, notwithstanding the approach taken by Hobhouse J.[37]

1.27 The approach of Hobhouse J to a definition of reinsurance was largely echoed by Lord Hoffmann in *Charter Reinsurance Co Ltd v Fagan*[38] who suggested that a contract of reinsurance is:

> . . . not an insurance of the primary insurer's potential liability or disbursement. It is an independent contract between reinsured and reinsurer in which the subject matter of the insurance is the same as that of the primary insurance, that is to say, the risk, the ship, the goods or whatever might be insured. The difference lies in the nature of the insurable interest, which in the case of the primary insurer arises from his liability under the original policy: see Buckley LJ in *British Dominion General Insurance Company v Duder*.[39]

1.28 However, Lord Mustill was rather less keen to narrow the definition. He said that:[40]

> This is not the place to discuss the question, perhaps not yet finally resolved, whether there can be cases where a contract of reinsurance is an insurance of the reinsurer's liability under the inward policy or whether it is always an insurance on

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34 [1925] AC 639, 642.

35 See para 1.66.

36 *Phoenix General Insurance Co of Greece SA v Halvanon Insurance Co Ltd* [1985] 2 Lloyd's Rep 599, 611.

37 See, eg, *Baker v Black Sea & Baltic General Insurance Co Ltd* [1990] Lloyd's Rep IR 327, 334.

38 [1997] AC 313, 392.

39 [1915] 2 KB 394, 400.

40 [1997] AC 313, 385.

> the original subject matter, the liability of the reinsured serving merely to give him an insurable interest.

Thus he left open the possibility, without deciding the point, that in some cases a contract of insurance may more properly be regarded as being in the nature of liability insurance rather than a reinsurance of the original subject matter.[41] Potter LJ in *Skandia International Corp v NRG Victory Reinsurance Ltd*[42] was equally reluctant to resolve the general question as to whether, or where, the line should be drawn between reinsurance 'properly' or 'narrowly' so called and 'mere' liability insurance effected by a reinsurer.

1.29 It is suggested that for a contract properly to be understood as reinsurance there must be a contract between insurer and reinsurer whereby the insurer lays off some or all of its risk to the reinsurer for the payment of a premium in circumstances where the reinsurer has no contractual relationship directly with the ultimate insured.[43] Furthermore, the fact that the insurance is a reinsurance means that the extent of the reinsured's insurable interest has to be identified by reference to the terms of the original policy and that the reinsured must therefore give to the reinsurer the benefit of any protection which the reinsured is entitled to enjoy, or may have obtained under the original policy.[44] The indemnity afforded by reinsurance is therefore against the discharge of liability by the reinsured—the reinsured cannot make a profit out of the reinsurance.

1.30 However the possibility left open by Lord Mustill gives rise to the problem identified by Lord Mance in *Wasa International Insurance Co v Lexington Insurance Co*:[45]

> A conclusion that 'what is insured is the insurer's own liability' would not entitle the insurer to indemnity against whatever liability it might be found to have in any court in which it was sued, under whatever law was there applied. Insurance against liability may, like any other insurance, be subject to specific terms which have to be satisfied before any indemnity can be sought.

1.31 Lord Philips regarded it as a well-established principle when he commented in *Wasa*:[46]

> Essentially the result of this appeal is dictated by the agreed fact that the reinsurance contract that is the subject of the appeal is governed by English law and by the

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[41] Certainly he did not think that was the case in the policy before him when he observed: '...the policy covers...the occurrence of a casualty suffered by the subject matter insured through the operation of an insured peril. The Inward policies and the reinsurance are wholly distinct.'

[42] [1998] Lloyd's Rep IR 439, 457.

[43] In *Forsikringsaktieselskapet Vesta v JNE Butcher* [1989] 1 AC 852, 908 Lord Lowry stated that 'reinsurance is prima facie a contract of indemnity...under which the reinsurer indemnifies the original insurer against the whole or against a specified amount or proportion...of the risk which the latter has himself insured'. See also *The Zephyr* [1985] 2 Lloyd's Rep 529, 531–532.

[44] Hobhouse LJ in *Toomey* at 522–523. See also, eg, *British Dominion General Insurance Co v Duder* [1915] 2 KB 394, 401–402.

[45] [2010] 1 AC 180; [2009] 2 Lloyd's Rep 508, para 34.

[46] At para 2, citing *British Dominions General Insurance Co Ltd v Duder* [1915] 2 KB 394, 400.

> well established principle, not challenged in this case, that under English law a contract of reinsurance in relation to property is a contract under which the reinsurers insure the property that is the subject of the primary insurance; it is not simply a contract under which the reinsurers agree to indemnify the insurers in relation to any liability that they may incur under the primary insurance.

1.32 The concept of reinsurance was held to exist where the reinsurance contract was an insurance of surety bonds rather than of an underlying insurance risk. Contracts of reinsurance are excluded from the charge to insurance premium tax and in *Travellers Casualty v Commissioners of Customs and Excise*[47] the question for a VAT Tribunal was whether an insurance of surety bonds were contracts of reinsurance. Surety contracts are not themselves insurance,[48] but they are part of the business of an insurer and so when that insurer took out insurance with a reinsurer in respect of those bonds, that was held to be a reinsurance contract.

G. Types and Methods of Reinsurance

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1.33 Reinsurance is essentially a contract under which an insurer agrees to pass a defined part of an insurance risk to a reinsurer. The distinction between the two main types of reinsurance is in the way that this part is defined—proportional or non-proportional.

(1) Proportional Reinsurance

1.34 In the first main type of reinsurance, proportional reinsurance, the reinsurer agrees to take a proportional part or share of the liability of the insurer on a single risk or a number of risks and also takes an equivalent proportion of the premium (less commission). The reinsurer has an interest in all the insurer's losses as it will pay the proportion of such losses that he has agreed to reinsure, leaving the remainder to be paid by the insurer. For example, an insurer enters into a contract of insurance providing for £1 million of cover in the event of fire damage to a factory. The insurer then enters into a contract of reinsurance with a reinsurer who agrees to reinsure 75% of the risk. The reinsurer receives 75% of the premium (less commission). If a fire takes place at the factory and damage of £1 million results then the reinsurer will be liable for the payment of £750,000 (ie his proportion of the total liability), and the net cost to the insurer will be £250,000 (ie that part which he has retained).

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[47] [2006] Lloyd's Rep IR 63.

[48] The VAT Tribunal noted that the fact that s 95(a) of the Insurance Companies Act 1982 includes the effecting and carrying out of suretyship contracts did not make them contracts of insurance.

(2) Non-Proportional Reinsurance

1.35 In the second main type of reinsurance, non-proportional excess of loss reinsurance, the reinsurer reinsures a layer (or part of a layer) of the liability of the insurer on a single risk or a number of risks. Non-proportional reinsurance enables a reinsured to assume a risk or size of risk which it might not otherwise write, but for the protection afforded by the reinsurance.

1.36 The non-proportional reinsurer has little interest in any loss until it reaches a certain amount: the excess point. For a loss which is greater than the excess point, the insurer pays everything below the excess and the reinsurer pays that part which he has insured above the excess point.[49] Take the same example of an insurer entering into a contract of insurance providing for £1 million of cover in the event of fire damage to a factory. The insurer enters into a contract of reinsurance with reinsurer A for 100% of its liability in excess of £250,000 but up to a liability of the insurer of £500,000 (ie £250,000 in excess of £250,000) and a contract of reinsurance with reinsurer B for 100% of the liability in excess of £500,000 up to £1 million (ie £500,000 in excess of £500,000). Both reinsurers have reinsured a layer of the risk. If a fire takes place causing £200,000 of damage to the factory, neither reinsurer will be called upon to pay any part of the loss. If the loss caused by the fire is £450,000, the insurer will be liable for the first £250,000 but reinsurer A's layer of cover will also be caught and reinsurer A will therefore be liable for £200,000 (ie that part of the damage in excess of £250,000). If the loss caused by the fire is £1 million (or more), reinsurer A will be liable for £250,000 and reinsurer B for £500,000.

1.37 The difference between proportional and non-proportional reinsurance is fundamental. As Waller LJ said in *Bonner v Cox*:[50]

> Reinsurance is very much the life blood of the market. It may be proportional, such as a quota share which is in the nature of a joint venture between the reinsured and his reinsurer. Or it may be non-proportional, such as an excess of loss, which is written to protect an exposure to a particular risk (facultative), a particular class of risk or a whole account; it is a way in which an underwriter manages an underwriting account. The fundamental difference between these two types of reinsurance is that the former involves a sharing of risks (premium and losses) between reinsured and reinsurer. The latter, (with which we are concerned) does not.

1.38 A non-proportional reinsurer does not usually exercise any underwriting judgement as to the particular risks which he reinsures.[51] The assessment a reinsurer makes at the outset relates to the skill which it believes the reinsured has as the reinsurer will expect to follow the fortunes of that reinsured.

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[49] See, eg, *Balfour v Beaumont* [1982] 2 Lloyd's Rep 493, 496.

[50] [2006] Lloyd's Rep IR 385, paras 87–88.

[51] Indeed other than in facultative reinsurance, a reinsurer rarely exercises independent underwriting judgement: see Waller LJ said in *Bonner v Cox* [2006] Lloyd's Rep IR 385, para 89.

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1.39 Excess of loss reinsurance is comparatively modern, probably dating from transactions arranged by CE Heath (an underwriter at Lloyd's) in the United States in the last two decades of the nineteenth century.[52] Under such non-proportional reinsurance, the premium may be fixed but where the reinsurance is not simply protecting a single risk, it is commonly a minimum and deposit premium adjustable by reference to a percentage of the reinsured's net premium income. Claims on the risk(s) within the scope of the reinsurance are payable in excess of a specified figure, whether the cover relates to individual losses or to an accumulation of losses or on the whole or a particular part of the reinsured's account.[53] The more likely it is that a layer of reinsurance is going to be breached, the more the reinsurer will expect to be paid by way of premium.

H. Facultative and Treaty Reinsurance

1.40 A reinsurance programme will often be comprised of a combination of proportional and excess of loss or non-proportional reinsurances. These can be provided on a 'one-off' basis, with specific contracts of reinsurance designed to cover a particular risk ('facultative' reinsurance), or the insurer and reinsurer can enter into a continuing relationship under a 'treaty' whereby a class of risks or an insurer's entire account can be reinsured. The different forms of reinsurance, ie facultative and treaty, represent different tools which an insurer may deploy, frequently in conjunction with one another, to pass on or protect exposure either on particular risks or on the whole or part of its insurance account. The purpose is self-evidently to protect the insurer from exposures of the type reinsured which could otherwise either individually or cumulatively imperil the insurer's solvency or profitability.[54]

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I. Facultative Reinsurance

1.41 Facultative reinsurance is reinsurance for individual risks and each risk is considered individually. The central distinguishing feature of facultative reinsurance is that both insurer and reinsurer have a choice as to whether to enter into a reinsurance contract in respect of each risk. There is no obligation on the insurer to reinsure the risk. If the insurer does seek reinsurance, there is no obligation on the reinsurer to provide it.

1.42 Facultative reinsurance can be proportional or non-proportional. It was the predominant form of reinsurance probably until the early part of the twentieth century. It

[52] Per Lord Mustill in *Charter Reinsurance Co Ltd v Fagan* [1997] AC 313, 390.
[53] Per Mance J in *Charter Reinsurance Co Ltd v Fagan* [1997] AC 313, 341.
[54] Per Mance J in *Charter Reinsurance Co Ltd v Fagan* [1997] AC 313, 342.

has a number of obvious drawbacks. The administrative costs of having to consider risks on an individual basis are relatively high, and the time taken to do so may also be somewhat lengthy. Unsurprisingly, therefore, one most often sees facultative reinsurance being used to reinsure unusual or large risks.[55] Furthermore, an insurer will generally want a degree of certainty that if he insures a risk he will be able to obtain appropriate reinsurance for it. The facultative method, in its most traditional form (ie where insurance is effected first and reinsurance is then sought), is intrinsically uncertain—an insurer can take on a risk and then discover that he cannot obtain any reinsurance (or any reinsurance for a price that he wishes to pay).

(1) Proportional Facultative Reinsurance

1.43 The basic concept of facultative proportional reinsurance was summarized by Lord Griffiths in *Forsikringsaktieselskapet Vesta v JNE Butcher*:[56]

> An insurer who has accepted a risk by issuing a policy of insurance goes to reinsurers to lay off part of that risk. Before the reinsurer accepts part of the reinsurer's risk, he will wish to assess the risk for himself. The reinsurer can only assess the risk if he is shown the terms on which the insurer has accepted the risk; in other words if the reinsurer is shown the policy that has been or is to be issued by the insurer. When the reinsurer has assessed the risk covered by the policy he can then decide whether or not he will reinsure the risk. In the ordinary course of business reinsurance is referred to as 'back-to-back' with the insurance, which means that the reinsurer agrees that if the insurer is liable under the policy the reinsurer will accept liability to pay whatever percentage of the claim he has agreed to reinsure.

1.44 This is not, however, a complete description of facultative proportional reinsurance.[57] In many cases reinsurance is arranged, at least in principle, before insurance is effected. Furthermore, the description does not address the common and accepted practice of 'signing down' facultative proportional reinsurance[58]—whereby a broker will over-subscribe reinsurance (ie obtaining reinsurance cover for more than 100% of the risk, or for more than the amount which the reinsured has asked him to obtain, and then 'signing down' the over-subscription proportionately to 100%).[59]

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[55] In the insurance market, the problems posed by the placement of small facultative risks can be addressed by the broker arranging a line slip, which is an arrangement whereby the leading underwriter on the line slip has the authority to accept risks falling within its ambit on behalf of all the following underwriters subscribing to the line slip. Such an arrangement can also be set up for facultative reinsurance business that a broker anticipates receiving—see, eg, *Brotherton v Aseguradora Colseguros SA* [2002] 1 Lloyd's Rep IR 848.

[56] [1989] 1 AC 852, 893.

[57] As recognized by Tuckey LJ in *Groupama Navigation et Transports v Catatumbo CA Seguros* [2000] 2 Lloyd's Rep 350.

[58] Signing down lines can apply to any form of reinsurance which is over-subscribed.

[59] The percentage of a liability that the reinsurer will actually bear in practice will therefore depend on the extent to which the broker goes on recruiting subscribers after 100% of the risk has been written.

1.45 The classic description of market practice was described by Mustill LJ in *The Zephyr*:[60]

> ... a practice has developed whereby a broker instructed to obtain a primary cover will on his own initiative approach potential reinsurers to obtain from them in advance a binding promise to provide reinsurance for whatever person may subsequently write a line on the primary cover and desire to reinsure the whole or part of that line. The reinsurer conveys this promise by initialling a percentage line on a slip, which identifies the subject-matter, the nature of the risk and the value. The slip does not, however, identify the reassured and could not do so: for at the stage when the potential reinsurer is approached, it is not known whether the primary insurance will ever be written at all, and if so by whom; or whether any of the primary insurers will desire to effect reinsurance; or whether any insurer who does desire to reinsure will be willing to do so with the reinsurer whom the broker has approached, and on the terms which he has offered. With this promise 'at large' in his pocket, the broker can offer to an underwriter a package consisting of the opportunity to take a line on the primary cover, and at the same time to place an order for reinsurance.

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1.46 The commercial intention of proportional facultative reinsurance is for the original insurer to reinsure part of its own risk and for the reinsurer to accept that part of the risk. Therefore the relevant terms in the reinsurance contract should be construed so as to be consistent with the contract of insurance as a matter of commercial common sense. Consequently the starting point for the construction of the reinsurance policy is that the scope and nature of the cover in the reinsurance is co-extensive with the cover in the insurance. As Staughton LJ said:[61]

> One can ... readily assume that a reinsurance contract was intended to cover the same risks on the same conditions as the original contract of insurance, in the absence of some indication to the contrary.

1.47 An early example of this principle is found in a reinsurance of cargo in *Joyce v Realm Marine Insurance Co*.[62] The reinsurance was 'to commence from the loading of the goods' at West African ports. Goods were lost a day after the ship's arrival from Liverpool into an African port. Under the wording of the reinsurance it might seem as if the Liverpool cargo was not covered. However the terms of the insurance indicated that the outward cargo was to be considered as covered homeward cargo 24 hours after the ship's arrival at her first port of discharge. The Court held

[60] [1985] 2 Lloyd's Rep 529, 532. The Court of Appeal approved Hobhouse J's approach that the above, as a matter of market practice, produced a binding promise, but also that on a strict contractual analysis there was a binding contract once the reinsurance had been accepted, and even without communication of that acceptance to the reinsurers. Once a reinsurer had scratched the slip offering the reinsurance that was an open offer capable of acceptance simply by the offeree accepting or renewing the cover on the basis of that offer of reinsurance. See also *Bonner v Cox* [2006] Lloyd's Rep IR 385.

[61] In *Youell v Bland Welch & Co Ltd* [1992] 2 Lloyd's Rep 127, 132.

[62] (1872) LR 7 QB 580.

that 'loading' in the reinsurance applied to outward cargo from Liverpool which was left on board and considered as homeward cargo under the insurance. The reinsurance was read in the light of the insurance and showed that what was meant between the parties was not the actual loading, but a constructive loading. What was important was what the original underwriters had agreed to treat as a loading on board for the purpose of the homeward voyage.

1.48 The existence of back-to-back reinsurance is a matter of construction of the wording used by the parties in the context of the type of reinsurance and not any rule of law, as was emphasized in *Wasa International Insurance Co v Lexington Insurance Co*.[63] The fact that a reinsurer could offer non back-to-back cover if it selected the correct wording was explained by Lord Griffiths in *Vesta*[64] when he said:

> A reinsurer could, of course, make a special contract with an insurer and agree only to reinsure some of the risks covered by the policy of insurance, leaving the insurer to bear the full cost of the other risks. Such a contract would I believe be wholly exceptional, a departure from the normal understanding of the back-to-back nature of reinsurance and would require to be spelt out in clear terms. I doubt if there is any market for such a reinsurance.

(2) Non-Proportional Facultative Reinsurance

1.49 Non-proportional, excess of loss, facultative reinsurance is a somewhat rarer feature on the reinsurance landscape, although it is commonly found on the reinsurance of captives above a 'working' layer. The reinsurer will offer to reinsure only on a sum in excess of a particular figure on the risk. The insurer and reinsurer are free not to offer and not to accept. If accepted, the insurer will then retain liability for the entire loss below that excess; and the reinsurer for that part of the loss that he has agreed to pay above the excess. Reinsurers may favour this method as a mechanism for limiting their exposure and also for negotiating premium rates (ie not simply taking a share of the premium proportionate to the percentage of the risk that they have reinsured).

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J. Treaty Reinsurance

1.50 Treaty reinsurance is an agreement ('treaty') for reinsurance, at least in principle,[65] for a number of risks. By this method, insurer and reinsurer agree that all risks of the insurer of a certain type or types, and potentially the entirety of the insurer's book of business, will be reinsured by the reinsurer. Individual risks are not assessed

[63] [2010] 1 AC 180; [2009] 2 Lloyd's Rep 508.
[64] *Forsikringsaktieselskapet Vesta v Butcher* [1989] AC 852.
[65] The reason for the use of the words 'in principle' is that it may transpire that the insurer will not in fact have any business of a particular type during the currency of the agreement, and therefore will not cede any business of that type to the reinsurer.

by the reinsurer and premiums are decided in advance, reducing administrative costs and ensuring certainty of reinsurance cover simultaneously with the direct insurance being placed. The central distinguishing feature of the treaty method of reinsurance is that the insurer is obliged to cede to the reinsurer such risks as he has agreed to cede under the treaty and the reinsurer is obliged to accept those risks. It is the predominant method of reinsurance.

1.51 In *Hanwha Non-Life Insurance Co Ltd v Alba Pte Ltd*[66] the High Court of Singapore had to construe a reinsurance contract to decide whether it was facultative or obligatory. Both on a traditional construction of its brief terms (including a fixed premium, a limit of cover and monthly declarations) and when adopting the contextual approach outlined in *Investors Compensation Scheme Ltd v West Bromwich Building Society*,[67] the reinsurance was held to be open obligatory in nature. This meant that the reinsurance risk run by the reinsurer commenced immediately whenever the reinsured accepted a risk on the underlying insurance policy. Such obligatory or treaty reinsurance can be effected proportionally and non-proportionally, and there are various mechanisms of doing so within each category.

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K. Proportional Treaty Reinsurance

1.52 Under a proportional treaty the insurer agrees to cede a proportional share of all its business within the limits of the treaty, and the reinsurer agrees to accept that share. The limits of the treaty can be in relation to the type of risk, the amount of risk, the area for which the risk is provided (eg, only certain countries). However, once agreed the reinsurance is automatic—the insurer is obliged to cede and the reinsurer is obliged to accept all risks that are within the compass of the treaty. As with other proportional arrangements, the reinsurer will take a share of the premium equivalent to the proportion of the risk that he has reinsured (less commission).

1.53 There are two main types of proportional reinsurance treaty: quota share and surplus. These are considered in turn.

(1) Quota Share

1.54 By a quota share treaty, insurer and reinsurer are obliged to cede and accept a fixed share of each and every risk within the scope of the treaty. This is a simple form of treaty. In practice, it is common for reinsurers to limit the amounts that they will be required to pay in respect of each risk ceded. To give an example, the reinsurer

[66] [2012] Lloyd's Rep IR 505. The Court held that the reinsurer had no right to reject a later endorsement as the attachment of risk under the reinsurance contract was independent of the submission of declaration of the risk, applying *Glencore International AG v Ryan (The Beursgracht)* [2002] 1 Lloyd's Rep 574 and [2002] Lloyd's Rep IR 335.

[67] [1998] 1 WLR 896 at 912.

agrees by a quota share treaty to provide reinsurance to the insurer on all of its fire business in Scotland for the year 1 January to 31 December 2005 to the extent of 75% on each risk, and not to exceed £1 million on each risk. The insurer issues 1,000 policies for fire insurance in Scotland that year for a premium of £1,000 each. The reinsurer will take £750,000 of the premium (subject to any commission payments). There are five fires upon which the insurance cover is called. Four fires cause losses of £100,000, and the fifth causes a loss of £1,500,000. The reinsured is liable to pay his 75% share of £75,000 for the first four fires, but only £750,000 for the fifth fire (having limited his liability to £1 million for each risk).[68]

1.55 By this arrangement the reinsurer is dependent upon the insurer to write his business prudently, but has the comfort of knowing that both bad and good business will be ceded automatically. The reinsured cannot simply pick out the duff and keep the plums for himself.

(2) Surplus

1.56 By a surplus treaty, the reinsurer agrees to accept the liability above that which the insurer wishes to retain for itself. The insurer decides what sum it wishes to cede to the reinsurer depending on the size and the type of risk. The insurer's retention is called a line and rather than being expressed as a percentage total of the risk (as with quota share treaties) it is referred to as a specific monetary sum. The treaty will usually provide for a monetary limit to the retention. Any risk that falls within the retention is not passed to the reinsurer(s). However, where a risk is larger than the insurer's retention, that part over the retention is ceded to the surplus share treaty reinsurer(s) as a multiple of the sum retained by the insurer. At first blush this treaty appears to be somewhat complex, but in fact it is relatively simple—although it is perhaps best understood by way of example. An insurer wishes to obtain reinsurance for its fire business in circumstances where it wants to retain a maximum exposure of, say, £100,000 for each risk. It enters into a treaty with reinsurers to provide nine lines (ie nine times the retention of the insurer up to £100,000 each line, in this example a maximum available reinsurance of £900,000). Thereafter the insurer issues a policy of insurance to company A for fire damage insurance in the sum of £100,000 and decides to retain the entire risk itself. There is no surplus to cede to reinsurers under the treaty and the entire risk falls on the insurer. However, the insurer then issues a policy to company B for fire damage insurance of £100,000 but decides that it wants to retain only £10,000 of that risk. There is a surplus of £90,000 over the reinsured's retention. Under the treaty nine lines of £10,000 each (the sum retained by the reinsured) are automatically ceded to the reinsurers.

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[68] See *Forsikringsaktieselskabet National (of Copenhagen) v Attorney General* [1925] AC 639 for an early example of a quota share treaty coming before the courts.

1.57 A difficulty for the reinsured will of course arise if he wishes to reinsure a risk of, say, £2,000,000. Under the treaty, the maximum amount that the reinsured can retain for itself is £100,000 and the maximum amount that can be ceded to the reinsurers under the treaty is £900,000 (nine lines of £100,000 each). That leaves a reinsurance shortfall of £1 million and the reinsured will accordingly have to make alternative arrangements, perhaps facultatively, for the reinsurance of that part.

1.58 In practice, a reinsured will enter into a number of treaties with a number of reinsurers to cover the surplus; the treaties should generally be in identical form, and reinsurers will often reinsure part of a line rather than a whole line.

1.59 The insurer, through deciding what part of any risk that it wishes to retain, has the advantage of deciding what business it wishes to cede (although some surplus treaties may oblige the insurer to cede all business of a certain type). From the reinsurer's perspective this may be somewhat unattractive—the insurer may retain most of the lines on low risks but cede most of the lines on high risks.

1.60 There can be more than one surplus treaty, one effectively sitting on top of another.

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L. Non-Proportional Treaties

1.61 Non-proportional reinsurance is based more on claims than risks. The liability of the insurer is capped at a certain level (the deductible). Within that retained layer the insurer will remain liable for all losses. The reinsurer will be liable for sums that exceed the deductible (usually subject to a maximum limit), and it is not uncommon to have different layers of excess of loss reinsurance. Different types of non-proportional treaty are geared to the type of business being underwritten. There are two main types: excess of loss and stop loss.

(1) Excess of Loss

1.62 In a proportional treaty the reinsurer will be involved in every loss that is ceded under the treaty according to the predetermined amount for which it has agreed to be liable. In excess of loss treaties, the reinsurer only becomes involved in a loss when it exceeds the insured's deductible. Where the loss on any risk exceeds the deductible, the reinsurer becomes liable for that layer of the loss that it has agreed to reinsure. Clearly, the more likely it is that a layer of reinsurance is going to be caught, the more the reinsurer will expect to be paid by way of premium. Unlike quota share treaties, the premium paid does not have a proportional relationship to the premium paid by the insured to the insurer. The 'loss' covered can be referable just to losses on individual risks or can extend, for example, to all losses arising from one event.

1.63 An issue as to the order of presentation of losses arose in *Teal Assurance Co Ltd v WR Berkley Insurance (Europe) Ltd*,[69] in which the Court of Appeal found that a tower of insurance contracts was to be regarded as exhausted by reference to the order in which the insured's liability was established and ascertained or the insured incurred covered costs and expenses rather than by reference to the order in which the reinsured paid the losses, as the reinsured contended for the purposes of recovery from its reinsurers. An engineering company had a tower of insurance contracts providing it with worldwide cover for US$60 million any one claim, and in the aggregate annually in excess of the deductible and self-insured retention. Above the initial layer in the tower, there were three layers of excess of loss insurance written by the insured's captive insurer which were reinsured. Above the tower was a 'top and drop' insurance of £10 million per claim which operated once the tower was exhausted. This layer was also insured by the captive and was separately reinsured. However in the 'top and drop' insurance there was an exclusion of North American claims. The insurances issued by the captive each provided that liability should not attach until the underlying insurance had paid its limit. The question was whether the insurer could choose to pay the American claims first within the lower layers, thus leaving the reinsurer exposed to non-American claims at the top.

1.64 The top and drop insurance contract provided that once the indemnity provided by the underlying policies was exhausted then 'this policy shall continue in force as Underlying policy'. That provided for the 'drop'. Each excess insurance had an equivalent drop down clause and therefore as losses arose, each dropped down and became the underlying policy until it in turn was exhausted. The reinsured contended that the clause which provided that liability should not attach until the underlying insurance had paid its limit meant that a layer was not exhausted until payment was made under the policy and that this meant that the order of losses for the purposes of the programme was the order of payment by the reinsured. The Court of Appeal rejected this contention and held that the reinsured could not rely on the clause so as to re-arrange the order of losses by applying the limits of the tower to the payment of American claims leaving reinsurers of the 'top and drop' insurance to face non-American claims where those claims, according to the order in which the insured's liability was established and ascertained or the insured incurred covered costs and expenses, should have been paid by the tower. Such ability to manipulate liabilities was unlikely to have been the intention of the parties. As Longmore LJ said:[70]

> The fact is that the construction of the policies of insurance . . . does not lead to a sensible commercial result, while the reinsurers' construction (that the policies are exhausted in an orderly manner depending on the time when liability is established against Black and Veatch) does produce a commercially sensible outcome. In these circumstances, however much one may feel that [the insurers'] construction is one

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[69] [2012] Lloyd's Rep. IR 315 (at the time of writing there is an appeal to the Supreme Court pending).
[70] At para 16.

> possible construction, there is no doubt that the policies can bear the construction for which Mr Edelman QC contends on behalf of reinsurers. In these circumstances it is the more sensible commercial construction which is to be preferred, see *Rainy Sky S.A. v Kookmin* [2011] 1 WLR 2900 paras 21–30 per Lord Clarke of Stone-cum-Ebony.

1.65 The nature of excess of loss reinsurance was explored by Lord Mance in *Wasa International Insurance Co v Lexington Insurance Co* when he said:[71]

> Excess of loss reinsurance is underwritten on either a losses occurring or risks attaching basis. In other words, it is fundamental that such a reinsurance will respond in the one case to losses occurring during the reinsurance period, in the other to losses occurring during the period of policies attaching during the reinsurance period. To treat excess of loss policies as covering losses through contamination occurring during any period, so long as some of the contamination occurred or existed during the reinsurance period, would be to change completely their nature and effect.

(2) Stop Loss

1.66 Stop loss reinsurance comes in two principal forms (although sometimes also an amalgamation of the two)—namely excess of loss ratio and aggregate excess of loss, which are considered individually at paras 1.67 et seq. The difference lies in the way in which the stop loss excess is expressed to operate—in the former it is expressed as a percentage of loss to premium income; in the latter it is expressed as a particular sum. Stop loss reinsurance is a product commonly used to cover against an attritional level of losses on an account or part of an account and may or may not relate to losses of a particular type. They are usually written annually, but this is not invariably so, for example reinsurance for seasonal damage to, say, crops.

(3) Excess of Loss Ratio

1.67 By this method of reinsurance the reinsurer agrees to provide insurance to the reinsured in excess of an agreed annual loss ratio—based on the ratio of losses suffered by the insurer to the premiums received by it in a given year. For example, the reinsurer may agree to reinsure an amount of 20% in excess of 110% of the insurer's loss ratio. If in any given year the insurer's losses exceed 110% of its premium income, the reinsurer will be liable for all losses until the total amount paid out by the insurer amounts to 130% of the ratio. Thereafter the loss will fall back onto the reinsured. Because these treaties will generally run annually, it is common to see payments being made by reinsurers at the end of the year. However, such treaties frequently provide for payments to be made earlier when it is clear that the ratio excess will be breached, with any necessary reconciliation taking place at the year end.

1.68 In the light of the fact that it may become clear early in the year that the excess ratio will be breached, reinsurers will often want to ensure that the reinsured has some

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[71] [2010] 1 AC 180; [2009] 2 Lloyd's Rep 508, para 41, citing *Balfour v Beaumont* [1984] 1 Lloyd's Rep 272.

incentive to deal with further claims prudently. This is usually done by providing that the reinsurer will only be liable for, say, 85% of the aggregate of the losses that are represented by the losses that it has reinsured, thus furnishing the insurer with an incentive to keep losses to a minimum.

(4) Aggregate Excess of Loss

1.69 This form of reinsurance, sometimes called cumulative excess of loss or catastrophe excess of loss, performs essentially the same function as excess of loss ratio reinsurance—providing protection in respect of the general result of the reinsured—the difference being that a specific monetary amount is defined in the treaty.

1.70 An obvious danger for the reinsurer in underwriting this sort of reinsurance is that the reinsured may write much more business than the reinsurer anticipated when the reinsurance was effected. As such the losses incurred may reach an excess point rather more readily than at first had been anticipated. It is perhaps not unsurprising, therefore, that one often finds hybrid stop loss policies being effected in which the ratio and specified sums are both included, with the reinsurance cover provided expressed to be a maximum of one or the other.

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M. A Hybrid Method of Reinsurance—Facultative Obligatory

1.71 A facultative obligatory ('fac/oblig') arrangement (sometimes referred to as 'open cover') works in much the same fashion as a quota share treaty (ie a set proportion of a risk is ceded to the reinsurer), save for the very important difference that the insurer has a choice whether to cede any given risk to the treaty. The insurer cannot cede a risk unless it falls within the limits of the treaty; but he is not obliged to cede if it does. The reinsurer, however, has no choice; he cannot insist on a risk being ceded, and is obliged to take his share of the cessions. Thus the arrangements are facultative so far as the reinsured is concerned because he retains the choice as to whether or not to cede. So far as the reinsurer is concerned, the arrangement is obligatory, like a treaty.

1.72 Fac/oblig treaties are, unsurprisingly, less attractive to reinsurers than quota share treaties. They are subject to the obvious risk that the insurer will retain good business for its own account and cede poor business to the treaty. The main constraint upon the insurer in this regard appears to be a commercial one—it will have to exercise some restraint if it wishes to maintain a good reputation in the market and to conduct future business with existing and prospective reinsurers.[72] As Lord

[72] Per Lord Millett in *Aneco Reinsurance Underwriting Ltd v Johnson & Higgins Ltd* [2002] 1 Lloyd's Rep 157, 192.

Steyn said in *Aneco Reinsurance Underwriting Ltd v Johnson & Higgins Ltd*,[73] the difference between quota share and fac/oblig treaties is that:

> . . . a quota share treaty is not facultative so far as the reassured is concerned: he must cede a set proportion of every risk which falls within the limits of the contract, so that everything which meets those criteria is automatically ceded. By contrast fac/oblig treaties are plainly open to abuse. The reassured is able to put on to his reinsurer the least attractive pieces of qualifying business in his book, while keeping that he considers to be the best business for himself. A reinsurer will tend only to reinsure another underwriter on fac/oblig terms if he has considerable trust in the way that the reassured will use it.

1.73 However, it has been argued that there are also legal restrictions on the conduct of business by the insurer under a facultative obligatory reinsurance treaty. In *Phoenix General Insurance Co of Greece SA v Halvanon Insurance Co Ltd*[74] Hobhouse J held that facultative obligatory reinsurance, which imposes no restriction on the reinsured's right to choose whether to cede or not, without giving the reinsurer any equivalent right, necessitated the implication of a term, or terms, that the reinsured should conduct the business involved in the cession prudently, reasonably carefully, and in accordance with the ordinary practice of the market.[75]

1.74 In *Phoenix v Halvanon*[76] Hobhouse J said:

> The implication of these terms was not controversial before me. Both [expert] witnesses thought them appropriate. Even though the opinion of the witnesses as to what is appropriate and reasonable does not itself suffice to show that such terms should be implied, I am satisfied that such terms are necessary in the present transactions. The fac. oblig. nature of the transaction which imposes no restriction on the reassured's right to chose whether to cede or not to cede, without giving the reinsurer any equivalent right, does necessitate that the reinsured should accept the obligation to conduct the business involved in the cession prudently, reasonably carefully and in accordance with the ordinary practice of the market. In the general formulation the word 'reasonable' is to be preferred to 'due' and the duty to act prudently as if not reinsured is not an alternative but it is really a restatement of the same obligation, provided it is realised that the obligation does not preclude the plaintiffs from taking into account the added capacity to write business that the availability of the reinsurances give them. Such is, after all, one of the important purposes of any reinsurance. In general terms, it must also be pointed out that the overrider commission being paid to the plaintiffs in part specifically covers the cost of carrying out these obligations.

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[73] [2002] 1 Lloyd's Rep 157, 183.
[74] [1985] 2 Lloyd's Rep 599.
[75] See also section on implied terms in Chapter 3.
[76] [1985] 2 Lloyd's Rep 599, 613. Note that this was a case in which the contractual material was sparse and where the true contractual intention of the parties had to be inferred or implied. In many cases, therefore, matters will be dealt with expressly and there will be no need to imply such a term or terms. Hobhouse J stated that this term (or terms) was innominate and therefore the consequences of any breach for any particular cession or any individual claim or for the contract as a whole must depend on the nature and gravity of the relevant breach—at 614. Note further that the decision of Hobhouse J was overturned by the Court of Appeal, but not in respect of the matters set out above, in *Phoenix General Insurance Co of Greece SA v Administratia Asigurarilor de Stat* [1986] 2 Lloyd's Rep 552.

1.75 Although Hobhouse LJ seemed to endorse, in passing, his own earlier judgment as a general statement of the implied terms appropriate to reinsurance in *Toomey v Eagle Star Insurance Co Ltd*[77] this has received qualified judicial support since. In *Toomey* Hobhouse LJ suggested that *Phoenix v Halvanon* dealt with the terms to be implied into reinsurance contracts 'in order to ensure that the interests of the reinsurers or those to whom risks are ceded, are sufficiently protected'. However the Court of Appeal in *Bonner v Cox*[78] held that non-proportional reinsurance was not subject to such implied terms and was a different type of contract from the proportional facultative obligatory treaty.

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[77] [1994] 1 Lloyd's Rep 516, 523. It was also followed by Tuckey J in *Economic v Le Assicurazioni d'Italia* (unreported, 27 November 1996).
[78] [2006] Lloyd's Rep IR 385.