IADC COMMITTEE NEWSLETTER

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IN THIS ISSUE

Harmon C. Hayden of Hayden Law in British Columbia reports on fundamental issues of reinsurance law in Canada in view of the decisions in Swiss Reinsurance v. Camarin Limited, et al. Absent an express "follow the settlements" clause in reinsurance contracts, the reinsured will have to prove their loss in the same manner as the original insured and there must be a judicial determination on liability under the policy.

The Long and Winding Road: Reinsurance Issues in Canada

ABOUT THE AUTHOR

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One of the longest running legal cases in Canada on reinsurance is coming to an end after litigation spanning decades throughout the US and Canada. This is the case of *Swiss Reinsurance Company v. Camarin*. Although there were numerous judgments throughout the years, the most important decisions are the trial decision in the British Columbia Supreme Court—2012 BCSC 1006—and the British Columbia Court of Appeal decision—2015 BCCA 466.

Although the underlying facts are fascinating and literally span the globe—from product liability actions in California, Colorado, New Mexico, Oregon, Texas and Washington, to insurers and brokers from London, Switzerland, Barbados and British Columbia—the focus of this article will be on fundamental issues of reinsurance law. The primary issue under consideration is this article is this: In reinsurance law in Canada, must the reinsured prove its loss, both on liability and quantum, against the reinsurer in the same manner as the original insured in the absence of a "follow the settlements" clause in the contract of reinsurance? The answer from Canada is yes. The BC Court of Appeal states this clearly and unequivocally: A reinsured must prove its loss in the same manner as the original insured. In the absence of a "follow the settlements" clause, there must be a judicial determination on liability under the policy. The burden of proof is on the reinsured to prove on a balance of probabilities that the underlying plaintiff's loss fell within the risks covered under the original and reinsurance policies and that it was in matter of fact liable to the plaintiffs in respect of that loss.

I will first review some basic but contentious issues in the law of reinsurance. I will then review in brief some of the underlying facts in this litigation. Finally, I will review the primary issues in the law of reinsurance from the trial decision and the court of appeal decision.

At the core of reinsurance, there are the concepts of "follow the fortunes" or "follow the settlements". These concepts illustrate the unique business relationships between the reinsured and the reinsurer. The terms are sometimes used interchangeably which is analytically improper. It is more appropriate to view the concepts as separate and distinct. The "follow the fortunes" doctrine generally refers to the reinsurer's obligations to stick with the underwriting fortunes of the ceding company when the cedent's underwriting produces poor or unfortunate results. The "follow the settlements" doctrine refers to the reinsurer's obligation to indemnify the ceding company for judgments or settlements paid in good faith in a reasonable manner that are consistent with the terms of the underlying polices and the reinsurance contract.

The focus in this article is on the latter concept: "follow the settlements". The benefit to the reinsured is this: the reinsured has the freedom to make good faith decisions on settlement or judgment without having to relitigate the same issues

with the reinsurer. Thus, the reinsurer is bound by the reinsured's payment of settled claims as long as the settlement was made in good faith and without evidence of gross negligence, recklessness, fraud, or that the underlying claim was outside the scope of reinsurance coverage.

A long-standing issue has been the application of this doctrine to reinsurance contracts in the absence of a specific "follow the settlements" clause. A typical clause may read along the following lines: "Being a Reinsurance of and warranted same terms and conditions as and to follow the settlements of the reinsured." The effect of this clause is to bind the reinsurer to any settlements reached by the reinsured. What is the result if such a clause is absent from the reinsurance contract? The answer appears to vary depending on the time the question is asked, and the jurisdiction involved. Parenthetically, the parties to such contracts must be aware of the implications of governing law and determine what the governing law will be. Although I cannot profess to be an expert in American law on reinsurance, it appears that the question has produced conflicting decisions in multiple jurisdictions. Some jurisdictions appear to have applied a "follow the settlements" doctrine to all contracts of reinsurance whether expressly included or not, but this is not universal. In one case, *New Hampshire Ins. Co. v. Clearwater Ins. Co.*, 2015 N.Y. App. Div. LEXIS 2452, the court could not determine whether the clause in question was a "follow the fortunes" or a "follow the settlements" clause and referred the matter back to the trial level. In Canada, conflicting results were obtained in the Supreme Court and the Court of Appeal which will be discussed herein.

Returning to *Swiss Reinsurance Company v. Camarin*, one writer usefully summarized the underlying facts as follows:

Vancouver-based MacMillan Bloedel Ltd. purchased commercial general liability policies from American International Group Inc. during the 1990s, before MacMillan Bloedel was acquired by Weyerhaeuser Company Ltd. In 1993, MacMillan Bloedel had acquired roofing tile manufacturer American Cemwood Inc.

MacMillan Bloedel was served with several lawsuits alleging that defects in Cemwood tiles were causing damage in felt layers underneath those tiles on roofs.

In July 2003, AIG agreed to pay $70 million to settle some of those lawsuits. Court records indicate that AIG was 50% reinsured first by Camarin Limited, a captive reinsurance company and an indirect subsidiary of MacMillan Bloedel, and then by Swiss Re. Aon Reed Stenhouse Inc. had placed the reinsurance policies.

Swiss Re sought rescission of its reinsurance policies in a B.C. court, claiming material misrepresentation.

Court records indicate that MacMillan Bloedel received a report, commissioned to Anistics, which "quantified the warranty

exposure at a possible $22 million representing 8,100 of some 20,000 possible warranty claims." That report was disclosed to Swiss Re when MacMillan Bloedel applied for its 1997 policy. That report "did not purport to describe resulting damage claims," but between 1994 and 1997, homeowners had filed lawsuits alleging resulting damage.

In the underlying American Cemwood actions, between 1994 and 1997, there were 22 lawsuits alleging resulting damages. Class actions were presented with claims as high as $900,000,000. In the face of such exposure, AIG agreed to settlement in the sum of $70,000,000, seeking over $25 million from Swiss Re under reinsurance provisions. The Court of Appeal rephrased the issues before it as follows:

7] The reinsurance program in place for 1993 and 1995 to 1998 was structured as follows:

a) AIG insured MB and its subsidiaries under a primary layer of insurance, which is not at issue in this litigation.

b) AIG also insured MB under an umbrella layer of insurance, the subject of this appeal. Five policies were issued between 1993 and 1998, excluding 1994 (the "Original Policies").

c) Camarin reinsured AIG for 50% of its limits under five of the six Original Policies (1994 excluded), with a minor retention of a small percentage in some years, irrelevant for purposes of this appeal.

d) Swiss Re reinsured Camarin for 100% of its liabilities to AIG (the "Reinsurance Policies").

[8] We now turn to the underlying facts.

[9] In April 1993, MB acquired American Cemwood Inc. ("Cemwood"), whose business was the manufacture of roofing tiles from a composite of wood and cement. Almost from the beginning, MB's acquisition of Cemwood did not go well. As early as 1993 MB became aware there were performance issues with the tiles resulting in numerous warranty claims. Even before the Cemwood purchase, MB research scientists performing due diligence expressed concern about quality control in the tile manufacturing process at Cemwood. Following the acquisition, a series of memoranda authored by MB personnel throughout 1993 and 1994 discussed deficiencies becoming apparent with the tiles.

[10] Until 1998, MB treated the problem with the tiles as warranty claims, that is, a problem related to the product itself without consequential damage, and therefore not an insured loss. The Original Policies did not insure warranty claims, including (as is usual) an exclusion for damage to the property itself:

This policy shall not apply:…

C. to Property Damage to:

1. the Insured's products arising out of such products or any part of such products;

…

E. to damages claimed for the withdrawal, inspection, repair, replacement or loss of use of the Insured's products or work completed by or for the Insured or of any property of which such products or work form a part, if such product, work or property are withdrawn from the market or from use by anyone because of any known or suspected defect or deficiency therein;

[11] However, warranty claims began to present themselves in alarming numbers.

[12] Cemwood commissioned Anistics Ltd., a subsidiary of Aon, to prepare a report projecting the number of future possible warranty claims (the "Anistics Report"). This report, dated September 6, 1996, features importantly in this litigation. MB received the Anistics Report in September 1996. Swiss Re received the Anistics Report in November 1996. The report quantified the warranty exposure at a possible $22 million representing 8,100 of some 20,000 possible warranty claims. The Anistics Report did not purport to describe resulting damage claims. It was forwarded to various insurers including Swiss Re in an attempt to secure insurance coverage for the warranty claims.

[13] That is not to say, however, that there were no resulting damage claims. Between July 1994 and December 1997, homeowners filed about 22 lawsuits alleging resulting damage.

[14] In July 1996, MB received another report (the "Calcoast Report"), which it did not disclose to Swiss Re. The Calcoast Report was prepared in connection with a class action concerning the tiles and appeared to describe resulting damage claims rather than solely warranty claims.

[15] Claimants launched numerous lawsuits against Cemwood arising from defects in the tiles in 1997 and 1998. A class action lawsuit was commenced in Oregon in November 1997. This was followed by a 38 state product liability class action commenced in August 1998 (the "Richison Class Action").

[16] In early 1998, the magnitude and nature of the claims became so worrisome to MB that senior management instructed that notice of claims should be submitted to its insurers. Swiss Re contends that MB had much earlier knowledge of resulting damage. This was because defects in the tiles were causing damage to the felt layer installed underneath them in addition to damage to the product itself. Swiss Re received notice of the claims on December 2, 1998, and reserved its right to deny coverage. Ultimately, Swiss Re concluded that the policies for the years in question should be rescinded on account of MB's failure to notify it in a timely way of its knowledge that defective tiles were leading to resulting damage claims.

[17] In December 1999, a California court consolidated the Richison Class Action with the other class actions. MB and Cemwood commenced a parallel coverage action (the "Coverage Action") seeking indemnity from AIG under its policies. Specifically, the Coverage Action sought indemnity for claims for damages allegedly "arising out of property damage occurring during the policy period and allegedly caused by products manufactured, distributed, handled or sold by Cemwood and/or MB." It was also pleaded that AIG had a duty to settle the class claims within policy limits.

[18] In July 2003, AIG agreed in a final settlement to pay $70 million in settlement of both the Richison Class Action and the Coverage Action. The settlement was split evenly across the policy years, 1993 to 1998. The approximately $25 million at issue in this litigation is for amounts AIG invoiced Camarin in respect of the excess insurance layer.

[19] As noted already, Swiss Re did not accept its liability to contribute to the settlement. At trial, the judge dismissed Swiss Re's claim to rescind the policies and awarded Camarin the full amount of its claim, U.S. $25,092,872.81, plus interest payable from November 18, 2003, which was the date the California court approved the settlement giving rise to the payments said to be owing from Swiss Re. [See Order pronounced and settled on July 9, 2012, and June 18, 2013.]

In the trial decision, although numerous issues were considered, I will only highlight some of the central ones. The trial judge held that the omission of the "follow the settlements" clause by AON, albeit a clerical error, was negligent. Any alleged misrepresentation by Camarin was not material. Further, and most importantly, the trial judge held that the reinsurer was bound by the "good faith" settlements and was required to "follow the settlements" even absent an express clause to that effect. Conditional judgment was given to Camarin against AON on account of their failure to include a "follow the settlement" clause.

On appeal by Swiss Re, the Court of Appeal unanimously upheld the appeal and ordered a new trial. This was appealed to the Supreme Court of Canada which refused leave to appeal. I will review some of the holdings of the BC Court of Appeal:

- In insurance law, the consequence of a material non-disclosure, even an innocent one, or a material misrepresentation is to render the policy voidable.

- Given the dates that these events unfolded, the length of time it took to get to trial, and the inordinate delay in delivery of the judgment, it is appropriate that this Court redouble its efforts to attempt to determine the issues between the parties. We have considered the evidence available for each policy year in an effort to determine if this Court could

> make the necessary findings of materiality. Despite doing so, it is our view that a new trial is the only just result available on appeal. It would be neither feasible nor in the interests of justice for this Court to weigh the evidence in order to make the findings of fact necessary to dispose of the rescission claim: Hollis. This is particularly so given the highly complex nature of the evidence in this case: Morin. We reach this conclusion with considerable reluctance.

On the fundamental issues of reinsurance, the Court was unanimous in finding that the trial judge erred in finding the reinsured was not required to establish its obligation to pay the amounts as damages for liability imposed by law in the same manner as the original insured absent a "follow the settlement" clause. The Court of Appeal applied English law—*Commerical Union Assurance Co. v. NRG Victory Reinsurance Ltd* [1988] 2 All E.R. 434 (C.A.); *Toomey v. Eagle Star* [1994] 1 Lloyd's LR 516, et al—and held as follows:

[110] The principles arising from the foregoing cases may be summarized as follows: a reinsured must prove its loss in the same manner as the original insured; and, in the absence of a follow the settlements clause, there must be a judicial determination on liability under the policy. It follows that in order for Camarin to prove its loss in the same manner as the original insured (MB), Camarin would need to demonstrate that MB/Cemwood was subject to a "liability imposed by law" that fell legally within the coverage of the policy. Camarin would need to show that MB/Cemwood would have been liable in the Richison Class Action, for damages insured under its policy. These principles are sensible. The fact that a settlement may be reasonable to a primary insurer cannot be determinative because the primary insurer may well settle for reasons that are extraneous to the merits of claim - for instance (as was the case here) to avoid exposure to a bad faith claim.

[111] Applying these authorities to the facts of this case, the test relevant to the circumstances of this case may be stated in the following way:

In the absence of a follow the settlements clause or specific policy wording concerning settlements:

a) The reinsured, Camarin, must prove its loss, both liability and quantum, in the same manner as the original class plaintiff would have had to prove its case against MB/Cemwood in the California court, (omitting for convenience AIG's role).

b) The burden of proof is on Camarin to prove on a balance of probabilities that the class plaintiffs' loss (as it would have been proven in California) fell within the risks covered under the original and reinsurance policies for each policy year and that it was as a matter of fact liable to the underlying insured, MB, in respect of that loss.

[112] At trial, the parties considered the first and second questions in accordance with California law, the jurisdiction in which both issues were to be tried, had they not been settled. We were not told the basis upon which the parties decided that California law governed the Coverage Action. Generally speaking the law governing insurance coverage is not determined by the location of a particular action. This is particularly so in regard to policies like those in this case which cover global risks: see Lombard General Insurance Co. v. Cominco Ltd., 2007 BCCA 249, aff'd 2009 SCC 11. On appeal, no issue regarding the choice of law was raised before us, so it is unnecessary for us to consider this question further.

As previously stated, the Supreme Court of Canada refused leave to appeal this decision. Thus, this remains the leading case and the present law of Canada on the issues herein.

The retrial of this matter was scheduled for a 145 day trial commencing in October of 2018. I was advised by counsel on November 19 that this trial did not proceed. They advised as follows: "You are at liberty to say the trial was adjourned and the court was informed there was an agreement that required certain steps to be taken."

Thus, this long and winding litigation has come to an end and the law is presently settled in Canada, in accordance with English precedent. As stated, underwriters and brokers should carefully consider whether they intend to include a "follow the fortunes" or "follow the settlements" clause and determine the law of the jurisdiction that will apply to the interpretation of reinsurance contracts.

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