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Case Note

Equitas Insurance Ltd v Municipal Mutual Insurance Ltd: The Fairchild Enclave and allocation of losses in reinsurance

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The complex nature of claims for compensation for losses suffered by employees exposed to asbestos at work who later developed mesothelioma led to the Fairchild Enclave in English law. Until Equitas Insurance Ltd v Municipal Mutual Insurance Ltd (’Equitas’),¹ the courts and Parliament had resolved the legal questions as to how to prove and calculate employers’ liability towards the employees and insurers’ liability towards the insured employers. These solutions, such as adopting a ‘weak’ causation test in establishing liability, were controversial and inevitably, those contentious results offered by the law caused disputes between the insurers and their reinsurers, which can now be observed in Equitas.

Facts

The relevant employers’ liability (‘EL’) insurance policies provided annual covers between 1 January 1950 and 31 December 1981 without any deductible and limit. The insurer, Municipal Mutual Insurance (‘MMI’), reinsured its liability under a number of annual excess of loss reinsurances, the retention and layers of which varied from year to year.

An employee’s claim for mesothelioma against an employer was to be resolved under the special rule of causation created by the House of Lords in Fairchild v Glenhaven Funeral Services Ltd² and s 3 of the Compensation Act 2006 (UK). Accordingly, any employer who has exposed a victim to asbestos in breach of duty is liable in full to a victim of mesothelioma, no matter how short the period of exposure for which it was responsible. Insurers’ liability is determined in the same way, so MMI was liable in full to indemnify the employer, again regardless of the period for which it had provided insurance (International Energy Group Ltd v Zurich Insurance plc UK Branch (‘IEG’)).³ It is open to insurers, here MMI, to seek contribution by reference to time on risk from other employers (and their insurers) who had exposed the underlying claimant to asbestos or from its insured for any uninsured periods.

MMI, therefore, settled the claims with no apportionment between particular policies or years and, following the Supreme Court’s ruling in the

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¹ [2019] EWCA Civ 718 (‘Equitas’).
² [2003] 1 AC 32.
³ [2016] AC 509 (‘IEG’).
Trigger litigation (Durham v BAI (Run Off) Ltd),\(^4\) presented all of its losses to the most favourable year of reinsurance coverage (in particular to avoid putting in claims in years where one of the participating reinsurers had become insolvent), a practice known as ‘spiking’. The Trigger litigation discussed the scope of the ‘injury sustained’ and ‘disease contracted’ insurance policy wordings and ruled by majority that both phrases meant exposure. This decision was also the result of policy decisions designed to ensure that victims were not prejudiced by lack of insurance coverage for all periods or possible insolvency or run-off of insurers. The question in Equitas was how to assess ‘spiking’, and therefore, the Fairchild Enclave, in the context of reinsurance.

The parties opted for the highly unusual — possibly unique — procedure of appointing a judge arbitrator, in order to secure what was in all but name a High Court judgment, but one that was confidential. The parties, however, did not exclude the right to appeal on a point of law under s 69 of the Arbitration Act 1996 (UK) (‘1996 Act’). The Court of Appeal granted permission to appeal because of the issues’ general public importance, rather than one-off, thereby attracting the lower threshold test of ‘open to serious doubt’ under s 69 of the 1996 Act.

**Allocation of losses in reinsurance contracts**

Through the financial backing of reinsurers, insurers may expand their insuring capacity and maintain their solvency. An insurer may insure and then reinsure a risk over a period of time with a number of different reinsurers. The insurer is a party to the original insurance and the reinsurance contracts; whilst it is the paying party towards the original assured, it makes a claim for that loss against the reinsurers. These two contracts, the original insurance and reinsurance respectively, are independent of each other but also the former forms the latter’s liability. Each contract is subject to its own terms about the scope of the cover including insured and excluded risks and duration. In the non-proportional excess of loss reinsurance treaties, as seen in Equitas, the reinsurers face liability only if the reinsured’s aggregate losses exceed the agreed retention figure. For instance, R1 may reinsure year X with an aggregate policy deductible of £50,000, whilst another year’s loss may be reinsured by R2 with an aggregate £100,000 deductible. If the latter loss is £70,000 in total, whilst R2’s liability does not arise at all, there is a chance of recovery of £20,000 from R1. The reinsured, who determines how to address the claim, would try to establish that the loss fell within the period covered by R1 but not R2. The English courts’ traditional approach to allocation of losses in reinsurance has been strictly in accordance with the correlation between the facts and the terms of the reinsurance policy. WR Berkley Insurance (Europe) Ltd v Teal Assurance Co Ltd (‘Teal’),\(^5\) decided that the reinsured cannot artificially manipulate its losses, for instance, by altering the order of them from the usual date on which liability is ascertained and quantified, in order to maximise recovery. In other words, the reinsured is not free to choose the

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4 [2012] 3 All ER 1161 (‘Trigger’).
5 [2017] EWCA Civ 25 (‘Teal’).
best reinsurance cover available unless the choice is legally justifiable. The
difficulty in *Equitas* was that MMI needed no artificial ordering; in light of
*IEG*, it was entitled to place losses in any one year to maximise its recovery.

Nevertheless, the Court of Appeal held that an extension of the anomalies
in terms of causation and allocation of losses between different responsible
bodies created by the Fairchild Enclave to reinsurance was neither necessary
nor justified. Males and Leggatt LJJ (Patten LJ agreed with both) put a great
emphasis on identifying the parties’ intention when they had entered into the
reinsurance contract with respect to the allocation of losses. Each party is
taken as promising in law to bear such perils that must have been in their
contemplation at the time they made the promises. The hurdle here was when
the relevant reinsurance contracts were made, the parties could not have
foreseen the situation that had arisen as a result of the law’s response to
mesothelioma claims. The court’s task was, despite possibly being artificial,
nevertheless to consider how reasonable parties should be taken to have
intended the contract to work in the circumstances which have in fact arisen.
In this respect, it was necessary to prioritise the fundamental nature of liability
insurance and reinsurance, the annual characteristics of the reinsurance
policies, certainty and predictability anticipated by the parties and preserving
the correlation between the premium and risk. On the other hand, consistent
with *IEG*, in the absence of any valid basis on which to distinguish insurance
and reinsurance, MMI was prima facie entitled to present the whole of its loss
to any reinsurance year of its choice. Two obstacles have to be overcome:
distinguishing insurance from reinsurance in this respect and interfering with
MMI’s power to allocate the reinsured losses in the reinsurance claim. The
former was dealt with smoothly by an anomalous solution in *IEG* which held
each insurer liable for 100% of the loss. True that this solution did not
coincide with the fundamental nature of insurance but it was necessary to
ensure victims protection. Moreover, in *IEG*, the insurers were in favour of
applying the Fairchild Enclave in order to avoid parliamentary intervention.
Once the desired objective has been achieved, the anomalies should be
corrected and in the reinsurance context, the law should return to the
fundamental principles of the common law. The legal tool through which these
results would be achieved was to imply a term in the reinsurance contract that
disallows MMI to spike the reinsurance claim. This solution would mean
interfering with MMI’s contractual power to allocate the losses, but Males and
Leggatt LJJ each preferred a different way of justifying such an intrusion.

Whilst Males LJ was not in favour of introducing new distortions which
may themselves have unpredictable consequences in order to patch over the
existing ones, Leggatt LJ did not hesitate to reiterate what in principle he
proposed in *Yam Seng Pte Ltd v International Trade Corporation Ltd*, namely
good faith as a duty implied by law.

**Good faith**

The duty of good faith (or utmost good faith as referred to by s 17 of the
*Marine Insurance Act 1906* (UK) (‘*MIA 1906*’) is one of the areas where

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insurance and general contract law principles divide. Before it was partly repealed by the Insurance Act 2015 (UK) (‘IA 2015’), the MIA 1906 regulated the pre-contractual information duty in business insurance under the title of the duty of utmost good faith. This was a mutual duty as worded in s 17 of the MIA 1906 whose breach would be met by avoidance of the contract. The duty of utmost good faith used to be understood primarily appearing in the form of the pre-contractual duty to disclose material facts and the duty not to misrepresent them. This limited approach to the scope of the duty of utmost good faith raised question marks as to the application of the duty in its general sense at any other stages of the contract. The common law courts recognised that circumstances that may be described as acting in bad faith or capriciously or arbitrarily, or in contravention of what fairness and businesslike actions require, would attract the duty of utmost good faith. However, the obstacle was the only remedy attached by the statute to any contravention of the duty of utmost good faith: avoidance of the contract. Treating the contract as if it never existed was not adequate when a contract was binding and performed by the parties, until the situation that required discussing the duty of good faith arose. Such a concern led the courts to be very careful and restrictive about mentioning the duty of utmost good faith in its general sense at the post contractual stage. Nevertheless, in Drake Insurance plc v Provident Insurance plc (‘Drake’), the insurer’s attempt to avoid the insurance contract, where there would have been no inducement had there been full disclosure of the assured’s accident history, was described as not acting in good faith. In Horwood v Land of Leather Ltd (‘Horwood’), a term was implied to restrain the assured from prejudicing insurer’s subrogation right, and acting in contravention of it was described as not acting in good faith. Good faith in its general sense was also discussed in the case of making a fraudulent insurance claim (Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd (‘The Star Sea’)).

Equitas was decided under the statutory regime applicable prior to the IA 2015. It is suggested that Males LJ’s reasoning contains some inconsistencies possibly derived from his Lordship’s attempt to avoid the doctrine of the duty of good faith. The post-contractual duty of good faith in insurance contracts, in the sense that the courts were cautious about the draconian statutory remedy of avoidance, in view of Males LJ, had no part to play in the current context. A wider concept of good faith in insurance contracts which extends, at least in some contexts, to a requirement of reasonableness in the making of contractual choices, did not represent English law. In any event, his Lordship preferred to leave it to another case to develop such a doctrine if it was necessary. On the other hand, Males LJ referred to Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd [Nos 2 and 3] (‘Gan’), in which the reinsurers’ contractual power to reject the approval if a settlement reached by the reinsured with its assured, was held not to be exercised arbitrarily. Males LJ denied that such constraint in Gan derived from the

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7 [2004] QB 601 (‘Drake’).
8 [2010] Lloyd’s Rep IR 453 (‘Horwood’).
9 [2003] 1 AC 469 (‘The Star Sea’).
10 [2001] Lloyd’s Rep IR 667 (‘Gan’).
insurance duty of utmost good faith, but the nature and purpose of the particular contractual provisions justified that restriction.

The crux of the issue is managing a clear conflict of interest by one party when that party is making a decision which affects the rights of both parties to the contract (Braganza v BP Shipping Ltd). A clear conflict of interest between the parties and a significant imbalance of power arises out of the control which the insurer can exercise in allocating its inwards claims and its exclusive knowledge of its reinsurance arrangements over an extensive period. Males LJ’s proposed solution to overcome the profound concern of abuse of power was to imply a term as to the manner in which such powers may be exercised: absent of arbitrariness, capriciousness, perversity and irrationality. In holding so, Males LJ found support from the willingness of the Supreme Court to ‘strike new ground’ if necessary to achieve a fair balance of all the interests concerned. Clearly, his Lordship did not find such willingness sufficient to develop a doctrine of good faith. Ultimately, however, Males LJ could not avoid mentioning it, but then described good faith as a mere label in this context.

Leggatt LJ held that a term imposing constraints upon the reinsured’s exercise of contractual choices was to be implied in order to achieve the business efficacy as formulated in The Moorcock). Moreover, his Lordship was more convinced than Males LJ was that the doctrine of good faith in this context required a contractual power to be exercised in a way which was consistent with the justified expectations of the parties arising from their agreement, construed in its relevant context (Equitable Life Assurance Society v Hyman). In this respect, Leggatt LJ also referred to Gan in holding that as good faith requires, the reinsured should not exploit power which it was not intended to have for its own commercial advantage but should exercise it in a way which is as consistent as possible with the assumption of risk for which the reinsurance premium was paid. Insurance does not operate on a basis which allows the insured to select the period and policy to which a loss attaches. This is elementary. If insureds could select against insurers in this way, the risks undertaken by insurers would be entirely unpredictable. It followed that liability between defendants should be apportioned according to relative contribution to risk and that this was what fairness demanded (Barker v Corus UK Ltd).

**Contribution and recoupment**

An insurance and a reinsurance contract can be written in an excess of loss form. The scheme operates by following the same logic: the retention bears the loss first, then the loss is claimed from the first layer in excess of the retention and then, once the first layer is exhausted for the amount exceeding it, the second layer will be the next stage of the claim. This methodology is followed either until the full compensation is achieved or the (re)insurance cover in layers is exhausted; whichever occurs first. On the reverse, if a

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12 (1889) 14 PD 64.
13 [2002] 1 AC 408.
14 [2006] 2 AC 572.
recovery is obtained from a third party who caused the loss, that recovery is first allocated to the insurer that insured the very top layer and the recovery moves back down layer by layer until the assured’s retention (Lord Napier v RF Kershaw Ltd). The higher layers of insurance are more remote from the loss in that their liability does not arise until the lower layer insurers’ liability is exhausted. Therefore, the higher layers of insurance should not be liable until the retention and any lower layers have been exhausted.

If ‘spiking’ was permitted, and therefore, Equitas was to pay the entire claim addressed by MMI, a further question would arise with respect to contribution from outer reinsurers and recoupment from MMI for the period that no reinsurance cover was available. Males LJ was in favour of adopting a flexible approach in applying equitable principle of contribution (doctrine that applies in double insurance) in order to achieve a just solution to the unconventional problems arising from the Fairchild Enclave. It was impossible to identify in which year the critical exposure occurred in the case of any given victim. Where a group of victims are in question, such exposures would have occurred in a variety of years. The best available measure of such exposures was by reference to each policy year’s contribution to the risk. It followed that instead of applying one single retention, MMI would bear a retention for each year of exposure. For Males LJ, recoupment was also justified for the years that MMI chose not to reinsure. Leggatt LJ however, for reasons which are not easy to reconcile, differentiated insurance and reinsurance in this respect, and rejected both contribution and recoupment in the reinsurance contract because of being complicated, burdensome and, unconventional, whereas a simple, principled and orthodox solution was at hand. His Lordship, presumably, found it justified at the reinsurance level, finding a simple solution by adopting one deductible only, which seems to be a businesslike approach to reinsurance rather than grounded on any legal basis.

Conclusion

Equitas was resolved by a conventional application of contract law, by implying a term designed to reflect the parties’ intentions at the time of the contract. To do this with respect to contracts made many years earlier, where the issues raised could simply not have been contemplated, was wholly artificial, and indeed, but for the interpretation in Trigger and IEG, none of this would have arisen. The Court of Appeal, by their artificial exercise, appears to have chosen to draw a line under the initial inauthenticity of Trigger and IEG to overcome both of these.

In Equitas, the old form of s 17 of the MIA 1906 was applicable. Under s 17, the most significant hurdle for the judges who observed contraventions of the post-contractual duty of utmost good faith had been the statutory remedy of avoidance at any stage that a contravention to the duty observed. Hence, whilst Gan clearly recognised that post-contractual duty, it nevertheless had to add that the duty derived from its contractual context. Although Males LJ refused to do so and Leggatt LJ did so via implied term of duty of good faith,
this note suggests that the post-contractual duty of utmost good faith in insurance could also have been relied on. *Drake, Horwood, Gan, The Star Sea and K/S Merc-Scandia XXXXII v Lloyd’s Underwriters (‘The Mercandian Continent’)* would support that conclusion. The Court of Appeal has granted leave to appeal to the Supreme Court whose view on the extension of the Fairchild Enclave to the reinsurance context is awaited.

However, the post-contractual duty of utmost good faith and its controversies will not be long lived. After the amendments made by the *IA 2015*, the post-contractual duty of good faith is more freely available without the previous restraints that the courts had to face. In its revised form after the *IA 2015*, s 17 of the *MIA 1906* retains the duty of utmost good faith with no express remedy determined by the section. The scope of the duty and its remedy were left to the common law courts. The pre-contractual duty of disclosure and the duty not to misrepresent material facts are separated from s 17; they are governed by the *IA 2015*, named as the duty of fair presentation of the risk. This clarity now grants to the Courts the desired flexibility to apply the duty of utmost good faith at any stage of the insurance contract where they find that justice requires them to do so.

**Australian law**

Final note should be made with regards to the analysis of the mesothelioma claims by the Australian Courts who refused to adopt the ‘special rule’ of the Fairchild Enclave. Clearly, the *Insurance Contracts Act 1984* (Cth) does not apply to reinsurance contracts (s 9(1)(a)). The High Court held in *Alcan Gove Pty Ltd v Zabic* that the mesothelioma victim’s cause of action in negligence accrued and became recoverable when the initial mesothelial cell changes occurred. Moreover, in *Amaca Pty Ltd v Booth* the High Court of Australia refused to follow the Fairchild Enclave and discussed whether the claimant satisfied the necessary burden of proof. The majority of the High Court approved the holding of the trial judge that the claimant’s evidence, on the balance of probabilities, established that the relevant exposure induced mesothelioma. The Australian Courts’ rejection to follow the Fairchild Enclave saves the interested parties to insurance and reinsurance contracts from debates similar to those discussed in the UK in *IEG* and *Equitas* as the estimation of the insurer’s and reinsurers’ liabilities will be made according to the conventional principles of insurance and reinsurance laws.

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18 (2011) 246 CLR 36.