The meaning of the words *actually paid* in the Ultimate Net Loss clause

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Finally, the House of Lords considered that the words «Actually Paid» did not indicate a previous condition. It was enough that Charter Reinsurance Co. Ltd. should show that it had a recognised and true obligation to pay its cedants.

On May 22, 1996, the House of Lords passed sentence in the case of Charter Reinsurance versus Lloyds Syndicates numbers 540 and 542.

The case has had enormous repercussions on the London market, not only because of the content of the sentence itself, but also because the sums which were initially in dispute total some £3 billion.

This report is a summary of the many studies which have been carried out for almost the last year by the publications and the lawyers' offices specialised in this sector.

The origin of the lawsuit:

Charter Reinsurance Company signed three XL contracts with Lloyds Syndicates 540 and 542, which included the Ultimate Net Loss (UNL) clause which is traditionally used in the London market in this type of business. The contracts stipulated that «The reinsurer shall only be liable if and when the Ultimate Net Loss sustained by the Reinsured exceeds £...» and the term UNL was defined in the following way: «The term Net Loss shall mean the sum actually paid by the reinsured in the settlement of losses after making deductions for all recoveries...».

Charter received notification of various very large claims and accepted them, despite the fact that it could not meet them because it had entered liquidation. It them claimed from the Syndicates the amounts for which they were liable, but the Syndicates refused the claim until Charter demonstrated to them that it had in its turn previously paid its own cedants.

The problem therefore lay in the interpretation of the words «Actually Paid»; the Syndicates maintained in the court of first instance, the court of appeal and in the House of Lords that the words should be taken quite literally and that a real and previous payment by their reinsured constituted a necessary precondition to obtaining the requested amounts.

For its part, Charter repeatedly argued that, on signing the contract, neither of the parties had had the intention of stipulating that the reinsured had to have the necessary liquidity to be able to settle possible claims before falling back on the protection afforded by the reinsurance contract.

The Sentence

The Commercial Court ruled in favour of Charter; the Court of Appeal ratified this sentence by a majority. Finally, the House of Lords unanimously ruled to the same effect, considering that the words «Actually Paid» did not indicate a previous condition. It was enough that Charter should show that it had a recognised and true obligation to pay its cedants, in other words, to show its liability, without there being the necessity to have actually physically transferred funds to them. This sentence arose from interpretation and from reinsurance and commercial tradition.

A summary of the main points of the judgement could be as follows:

– Although it is true that at first sight the clause could mean that the reinsurer has to suffer some kind of «financial detriment» before recovering funds from the reinsurer, in such a specialised type of reinsurance the wording must be analysed within the global context of the contract, and also bearing in mind the commercial nature and objectives of the transaction. If this is done, the words lose their literal meaning and instead refer to the calculation of the net loss to determine that what the reinsurer must pay is exactly the same as what the reinsured has to pay, as the liable party, to its cedant. Here, «actually» means «when the loss has finally been ascertained», and «paid» means «exposed to liability as a result of the loss insured».

– The risk which is insured through an XL contract is not the loss of the cedant as a consequence of a claim of its original insured, but the losses suffered by this latter party due to the occurrence of an insured event, the policies which have been underwritten between the initial insured and the cedant bear no relation to the rights and obligations which exist between the cedant and the final reinsurer.

– Only two conditions are necessary for an XL contract to be executed: that the loss should take place during the period in which the policy is in force, and that the final compensation should reach a quantity which brings a certain reinsurance layer into play.

– The London market operates on the principle that the XL contract completely frees the reinsured from the responsibility of paying claims covered by reinsured layers.

– Solvency regulations applicable to the insurers consider that reinsurance cover reduces their liabilities. It would therefore not make sense that they - by definition - had

to pay first, using their own funds, and then recover the payment from their reinsurers.

– This conflict would have been avoided if the contract clauses had used clearer and unequivocal wordings. The solution suggested by the Court of Appeal was however not sufficient: the conditions would have been clearer if they had contained the clause which is used by the protection and indemnity clubs: «shall have become liable to pay and shall have in fact paid».

– Lastly, the court's role is to clarify what the parties had actually meant in the light of the written terms of the contract, and not to limit themselves to taking a purely literal view of these terms.

Reactions and possible future consequences

– The Department of Trade and Industry, the body which ultimately governs insurance in the United Kingdom, and which takes possible reinsurance recoveries into account when evaluating the solvency of a company, had already formally expressed its worries to reinsureds regarding the possibility of a ruling favourable to the Syndicates and has asked them, when next presenting their accounts, to make a note of any possible reductions of assets in the case that in the future they were not able to obtain advance payments of funds from reinsurers.

A sentence different from that which was finally passed would have meant that the DTI would have to revise its solvency criteria. Logically, it has shown its satisfaction at the result of the case, and it is understood that in the future it will try to prevent the parties from including contractual clauses which set clear conditions of advance payment.

– Company liquidators in insolvency situations are also very satisfied; often reinsurance recoveries are the only sizeable assets in such cases, a sentence against Charter would have been most unfavourable for these companies. It is also considered that the obstacle which had been in the way of the recovery of several thousand million pounds has been removed, which may also prevent several potential insolvencies.

– Concerning the parties which are directly or indirectly affected, it is thought that the reinsured will in future try to include conditions in completely unequivocal terms stipulating that the reinsurer has to respond without a previous payment having been made, as is suggested by the sentence.

The underlying argument is that if the reinsurer is not insolvent but has liquidity problems, having to make advance payments could lead to insolvency, above all in the case of large claims which have to be settled in a short period of time.

For their part, the reinsurers defend previous payment because, according to them, this measure would mean that the reinsured would keep a stricter eye on claims and, in some cases, it would prevent the use of advanced funds for matters which are not related to the payment of claims.

– What is clear is that the sentence will have a great impact if one takes into account its broad affects, although the figures must be considered in gross terms: some of Charter's reinsurers and some of the syndicates' retrocessionaires are insolvent; the creditors are at times also debtors, so probably what should occur is that one balance should be set-off against another.

– Finally, other opinions of some experts are: the sentence is based more on commercial and economic considerations that on the strict application of legal principles; at the moment it is only applicable to XL contracts, so it remains to be seen what influence it may have on other types of contracts; as it is thought that there will be a high number of claims for payment to the reinsurers, it is foreseeable that it will have a great impact on the reinsurance and retrocession market.

We must sadly make mention of the sudden death of Mr Marino A. Zuluaga, Technical vice-president of Reaseguradora Hemisférica. His great human and professional qualities will not be forgotten by his colleagues in Bogota and in all the companies of the Reinsurance Unit of MAPFRE.