Case No: 2010 FOLIO 1045

Neutral Citation Number: [2011] EWHC 91 (Comm)
IN THE HIGH COURT OF JUSTICE
QUEEN'S BENCH DIVISION
COMMERCIAL COURT

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 31/01/2011

Before :

MR JUSTICE ANDREW SMITH

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Between :

Teal Assurance Company Limited	**Claimants**
- and -	
(1) W R Berkley Insurance (Europe) Limited	**Defendants**
(2) Aspen Insurance UK Limited	

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Roger ter Haar QC (instructed by **Davies Arnold Cooper**) for the **Claimants**
Colin Edelman QC (instructed by **Barlow Lyde & Gilbert**) for the **Defendants**

Hearing dates: 13 January 2011

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Judgment

Mr Justice Andrew Smith :

1. This is the trial of a preliminary issue about the proper construction and the operation of an excess reinsurance policy of professional liability insurance, and more specifically about how it is determined whether the "excess point" that triggers the reinsurance cover has been reached.

2. The claimants, Teal Assurance Company Limited ("Teal"), a company incorporated in the Cayman Islands, are wholly owned by Black & Veatch Holding Company, and are a captive insurance company that insures companies in the Black & Veatch group. The Black & Veatch group includes Black & Veatch Corporation, a major engineering company incorporated in Delaware and based in Kansas City, which operates directly or through associated companies in many countries. It is not necessary for present purposes to distinguish between the different companies in the group, and I refer to them simply as BV.

3. The defendants are insurance companies who on 30 October 2007 underwrote a policy (the "Excess Policy") which provided "Excess Claims Made Architects and Engineers Professional Liability Reinsurance" for the period from 1 November 2007 to 1 November 2008. They reinsured Teal. I shall refer to the terms of the Excess Policy below: it is subject to a limit of £10 million (or the equivalent in other currencies) for each claim, and does not cover claims emanating from or brought in the USA, its territories or possessions or Canada ("American claims").

<u>The trial of the preliminary issue</u>

4. By an order dated 28 October 2010 Simon J ordered the trial of the following question as a preliminary issue:

> "1. On the true construction of the Excess Policy:
>
> (1) Does the Excess Policy respond to claims arising in any one year outside the USA and Canada if and to the extent (subject to the limit of indemnity and any other applicable policy terms and conditions) that the total value of worldwide claims paid in any one year was to be such as to exhaust the insurance afforded by the p.i. tower, regardless of the order and timing of the establishment and ascertainment of the original Insured's liability or of the incurring of loss by the original insured?
>
> Or
>
> (2) Does the Excess Policy respond to claims having regard to the order in which claims are actually paid by the Claimant so that if and when payments made by the Claimant in respect of claims arising in any one year, whether within or outside of the U.S.A. and Canada, exhaust the reinsurance available in the p.i. tower, the Excess Policy responds to provide an indemnity in respect of payments made by the Claimant in respect of claims arising outside the U.S.A. and Canada (subject to other terms

> and conditions of the Excess Policy, for example as to limits of indemnity and exclusions)?
>
> Or
>
> (3) Does the Excess Policy respond to provide indemnity only upon exhaustion of the limits of liability of the underlying p.i. tower and any original Insured thereafter becoming liable to make any payments in respect of any claims against it or incurring costs and expenses falling within the ambit of Endorsement 008 to the Primary Policy, subject to the exclusion of US and Canadian claims and losses and subject to all other applicable policy terms and conditions?
>
> Or
>
> (4) Does the Excess Policy respond upon some (and, if so, what, basis) other that [sic] (1), (2) or (3) above?

The expression "p.i. tower" refers to the layers of BV's professional indemnity programme below that to which the Excess Policy responds.

5. As the agreed formulation of the preliminary issue explained, paragraphs (1) and (2) set out Teal's alternative pleaded cases as to the meaning of the Excess Policy, and paragraph (3) set out the defendants' pleaded case. In fact, in submissions before me Mr Roger ter Haar QC, who represented Teal, did not argue for the interpretation reflected in paragraph (2) of the preliminary issue, but he advanced as Teal's primary case a different construction that is not reflected in the formulation of the preliminary issue. Adapting the language of paragraph (2), this might be expressed as follows: "Does the Excess Policy respond to claims having regard to the order in which the claimant becomes liable to pay claims so that, if and when such claims exhaust the reinsurance available in the p.i. tower, the Excess Policy responds to provide an indemnity in respect of claims arising outside the USA and Canada (subject to the other terms and conditions of the Excess Policy, for example as to the limits of indemnity and exclusions)?"

6. The parties agreed a statement of facts for the trial of the preliminary issue, and there are no questions of fact for determination. The parties exchanged witness statements and also reports of expert witnesses, but little, if anything, in the statements and reports was admissible and relevant as evidence upon the preliminary issue. In the event neither party adduced factual or expert evidence from the witnesses, and the preliminary issue is determined on the basis of the agreed statement, and of the terms of BV's professional indemnity cover and the wording of the Excess Policy.

7. The agreed statement explains the structure of BV's professional indemnity cover at the relevant time, and the claims which have been made against BV and give rise to this litigation, and, as I understand it, the following descriptions are not controversial.

<u>BV's professional indemnity cover</u>

8. BV's cover was generally subject to a deductible of $100,000 in respect of each claim, but they carried a larger deductible of $250,000 for their insurance of costs and expenses that they incurred in rectifying design defects in construction or engineering works. Above the deductible, BV had a "Self-Insured Retention" (or "SIR") of $10 million for any occurrence, subject to an annual aggregate limit of $20 million. Teal insured the upper $5 million per claim of the SIR.

9. The first layer of insurance cover was underwritten by Lexington Insurance Company (by policy no 0101085, the "Lexington Policy"). The cover was on a claims made and reported basis, and the Lexington Policy provided cover limited to $5 million (per claim and in aggregate) excess of the SIR and deductibles. The insuring clause in the Lexington Policy provided cover in respect of BV's liabilities to third parties ("liability cover") and endorsement 8 to the policy provided cover for costs of mitigating losses ("mitigation cover"), these provisions being in the following terms:

> "The Company will indemnify the Insured all sums up to the Limits stated in the Declarations, in excess of the Insured's Deductible and/or Self-Insured Retention, which the Insured shall become legally obligated to pay as Damages if such legal liability arises out of the performance of professional services in the Insured's capacity as an architect or engineer and as stated in the Application provided:
>
> 1. such legal liability is caused by a negligent act, error or omission of the Insured or any person or organization for whom the Insured is legally liable or responsible, including the Insured's interest in joint ventures; or
>
> 2. in conformance with clause 24 of the Professional Engineers Act, the Claim is a direct result of a negligent act, error or omission by the Insured or arises out of a breach of Professional Duty by the Insured or the Insured's interest in a joint venture while supplying professional engineering services.
>
> …."
>
> and
>
> "In addition to the coverage granted under this Policy, but subject to the same Self-Insured Retention and limits of liability, we agree to indemnify the Named Insured for the Named Insured's Actual and Necessary Costs and Expenses incurred in rectifying a Design Defect in any part of the construction works or engineering works for any project upon which you are providing design/build services provided:
>
> A) the Insured reports the Claim for such Actual and Necessary Costs and Expenses as soon as practicable after discovery of such Design Defect but in no event after any certificate of substantial completion has been issued;

> B) the Insured proves to us that its Claim for Actual and Necessary Costs and Expenses arises out of the Insured's rendering of professional services which resulted in a Design Defect for which a third party could otherwise make Claim against the Insured..."

(There were definitions of the expressions "Actual and Necessary Costs and Expenses" and "Design Defect" in endorsement 8.)

10. The Conditions of the Lexington Policy included these:

> "V **SETTLEMENT**
>
> The Insured shall not settle any Claim without the informed consent of the Company, such consent not to be unreasonably withheld. …
>
> VI **ACTION AGAINST THE COMPANY**
>
> No action shall lie against the Company unless, as a condition precedent thereto, the Insured shall have fully complied with all the terms of this Policy, nor until the amount of the Insured's obligation to pay shall have been finally determined either by judgment against the Insured at the actual trial, arbitration or by written agreement of the Insured and the claimant, to which agreement the Company has consented…"

11. Above the Lexington Policy, BV had layers of cover underwritten by Teal in policies nos 2007-009, 2007-010 and 2007-011, which respectively provided insurance of $5 million excess of $15 million (that is to say, the amount of the SIR and the Lexington cover), of $30 million excess of $20 million and of $20 excess of $50 million. These policies (the "Intermediate Policies") provided that "Except as otherwise provided herein this Policy is subject to the same terms, exclusions, conditions and definitions as the Policy of the Primary Insurers …". The parties agree that the expression "Policy of the Primary Insurers" refers to the Lexington Policy. Accordingly the Intermediate Policies provided both "liability" cover and "mitigation" cover.

12. Each of these policies included provisions concerning the relationship between the policy and lower layers of the p.i. tower:

> "1. Liability to pay under this Policy shall not attach unless and until the Underwriters of the Underlying Policy/ies shall have paid or admitted liability or have been held liable to pay, the full amount of their indemnity inclusive of costs and expenses …
>
> 3. If by reason of the payment of any claim or claims or legal costs and expenses by the Underwriters of the Underlying Policy/ies during the period of this Insurance, the amount of indemnity provided by such Underlying Policy/ies is:-

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

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

I shall refer to these provisions as "clause 1" and the "drop clause" respectively.

13. The Intermediate Policies also provided as follows (in what I shall refer to as "clause 4"):

> "In the event of a claim arising to which the Underwriters hereon may be liable to contribute, no cost shall be incurred on their behalf without their consent being first obtained (such consent not to be unreasonably withheld). No settlement of a claim shall be effected by the Assured for such a sum as will involve this Policy without the consent of the Underwriters hereon."

14. In total, therefore, the Lexington policy and the Intermediate Policies, which comprised the so-called p.i. tower, provided cover of $60 million in excess of the deductibles and a SIR of $10 million for any one claim or $20 million in annual aggregate. The cover of the p.i. tower did not exclude American claims and was not subject to any such geographical limits.

15. Teal had reinsurance for the Intermediate Policies, but the terms of those reinsurances are not relevant to what I have to decide.

16. By policy no 2007-012 (the "Original Policy") Teal further insured BV for liability in excess of the p.i. tower. By it Teal agreed:

> "To indemnify the Insured for claim or claims first made against the Insured during the Period of Insurance hereon up to this Policy's amount of liability (as hereinafter specified) in the aggregate, the excess of the Underlying Policy(ies) limits (as hereinafter specified) in the aggregate, the latter amount being the subject of Indemnity Policy(ies) (as hereinafter specified) or any Policy(ies) issued in substitution or renewal thereof for the same amount effected by the Insured and hereinafter referred to as "the Underlying Policy(ies)"."

The Original Policy was denominated in sterling (not dollars, as the covers in the p.i. tower were), and the cover was limited to £10 million (or the equivalent in other currencies) for each claim. Like the Excess Policy, the Original Policy did not cover American claims, and the amount of liability and the limits of liability in the underlying policies were stated in similar terms to the provisions in the Excess Policy that I shall set out below.

17. The Original Policy included provisions similar to those in the Intermediate Policies that I have stated. It therefore provided both liability cover and mitigation cover in the terms of endorsement 8 to the Lexington Policy, and contained provisions similar to clause 1, the drop clause and clause 4. It also contained this provision ("clause 5"):

> "Any claim(s) made against the Insured or the discovery by the Insured of any loss(es) or any circumstances of which the Insured becomes aware during the subsistence hereof which are likely to give rise to such a claim or loss, shall, if it appears likely that such claim(s) plus costs and expenses incurred in the defence or settlement of such claim(s) or loss(es) may exceed the indemnity available under the Policy(ies) of the Primary and Underlying Excess Insurers, be notified immediately by the Insured in writing to the Insurers hereon."

Claims against BV

18. I am not concerned upon the trial of this preliminary issue with the validity of the claims made against BV, and I do not need to examine them in any detail. There might be issues between the parties about their validity and whether and how far they are covered by BV's insurance which will have to be determined later: my description of them is intended to be by way of background, and not to decide anything relevant to any such issue.

19. Teal bring these proceedings because BV have given notice in respect of two claims alleging professional negligence in respect of technical problems that have affected two construction projects.

i) One claim relates to the quality of treated water at the Ajman Sewerage Plant in the United Arab Emirates, which BV designed. According to the Agreed Statement of Facts:

> "Settlement discussions with the Employer are ongoing and the structure of the settlement is fairly complicated. However, in pure monetary terms, the overall effect of the various settlement documentation (taking into account costs incurred in carrying out remedial works to date) is that [BV] had, as at August 2010, expended the sum of approximately US$20.5 million in respect of remedial works for which it is responsible. It is anticipated that further remedial works will be required, and [BV] may in due course be required to contribute a further US$14 million towards the construction of further elements of the Sewage Plant (specifically an "Activated Sludge Plant") designed to improve performance".

I understand that, under the settlement terms (or proposed settlement terms), BV's further liability, in addition to remedial work that they have done, has been limited to $14.5 million, and this sum has been paid into an escrow account.

ii) The other claim relates to the Phoenix Park Gas Processing ("PPGP") facility in Trinidad. According to the Agreed Statement:

> "The [PPGP claim] relates to allegedly defectively designed piping and other accompanying supports at a gas plant in Trinidad. This required extensive remedial works to over 1,100 sections of piping. The total cost of the remedial works, which are now completed, was approximately US$9.5 million (after an applicable deductible of US$1,000,000 – there being four separate design issues which were deemed not capable of aggregation)."

Neither of these two claims is an American claim.

20. Of the other claims that have been brought against BV during the policy period, I need describe only two claims where the potential claimant is American Electric Power ("AEP"). The Agreed Statement describes them as follows:

> i) "The AEP (Fibre Glass Pipes) claim is essentially concluded, with [BV] having paid out its SIR (any one claim) of US$10 million. As at August 2010 total payments made (for both loss and expense) in respect of this matter are US$10.5 million (after an applicable deductible of US$250,000)."
>
> ii) "The AEP (Jet Bubble Reactor) claim is of much greater value. The claim concerns the alleged defective design of air venting and filtration systems for a number of power plants designed and constructed by [BV] in the USA for AEP, in respect of which it is stated that extensive remedial works are required. There have been long standing discussions as between [BV] and AEP as to the extent of the remedial works required. The latest estimate is that the total cost of the proposed remedial works could be in the region of US$210 million to US$240 million, and various agreements are in the course of being discussed between BVC and AEP as to how those remedial works are to be funded. As at August 2010, the total amount of costs and expenses incurred by [BV] is approximately US$7.5 million (after an applicable deductible of US$250,000). MCL have recommended a ground up loss reserve of over US$200 million."

These were American claims, and Teal recognise that they are not covered by the Excess Policy.

21. The AEP (Fibre Glass Pipes) claim exceeded the SIR limit for a single claim by some $500,000, and used some of the cover under the Lexington Policy. Some further part of the SIR, about $1.2 million, was used upon three other small claims. The remainder of the aggregate of the SIR has apparently been exhausted in view of the

Ajman Sewage Plant claim, the PPGP facility claim and the AEP (Jet Bubble Reactor) claim, but which of these claims exhausted it depends upon questions in dispute between the parties. According to Teal, both the SIR and the cover in the p.i. tower, apart from the small amount of cover under the Lexington Policy eroded by the AEP (Fibre Glass Pipes) claim, have been reserved to the AEP (Jet Bubble Reactor) claim; the remaining part of the cover under the Lexington Policy is about to be paid to BV; the reinsurers of the Teal policies in the p.i. tower are therefore not interesting themselves in the Ajman Sewage Plant claim or the PPGP facility claim; and BV have claimed against only the Original Policy in relation to these two claims.

22. Against this background, the dispute between Teal and the defendants arises, in broad terms, because Teal argue that the loss arising from AEP claims exhausts or is likely to exhaust the cover provided by the Lexington Policy and the Intermediate Policies, and so they were liable, or are likely to become liable, under the Original Policy in respect of the losses relating to the Ajman Sewage Plant and the PPGP facility. In these circumstances, they say, they can claim against the defendants under the Excess Policy. If Teal are correct, then they would be entitled (i) to recover for the two non-American claims under the Excess Policy, and (ii) to recover for both claims up to a limit of £10 million. The defendants contend that the losses relating to the Ajman Sewage Plant and the PPGP facility that have been sustained to date are covered by the Lexington Policy and the Intermediate Policies because at the relevant times the AEP claims had not exhausted those underlying layers of cover, and (as is common ground) that they are not liable in respect of the AEP claims because they are American claims. The issue does not arise not only because the Original Policy and the Excess Policy do not respond to American claims: even if they did, the implication of the defendants' argument is that, in the absence of any further non-American losses, they could be liable only for the AEP Jet Bubble Reactor claim and so their liability would be limited to £10 million.

The Excess Policy

23. Teal entered into the Excess Policy to reinsure their risk under the Original Policy. It was contained in a slip initialled by the defendant underwriters on 30 October 2007.

24. The Excess Policy stated that its interpretation is said to be governed by the "laws of the United Kingdom", which I would interpret, because the cover was underwritten in the London market, as meaning English law. (The Intermediate Policies stated that "any dispute concerning the interpretation of this Policy shall be governed by the laws of the USA", and this provision was incorporated into the Original Policy. The Lexington Policy had no choice of law provision. There is no suggestion that the law (or laws) governing these policies differs significantly from English law or affects what I have to decide.)

25. The "Interest" insured was stated to be:

> "INTEREST: Architects and Engineers Professional Liability as more fully defined in the primary policy wording, in connection with the Original Insured's business activities as Architects and Engineers."

There is no dispute that the "primary policy" is the Lexington policy and the interest relates to both liability cover and mitigation cover.

26. The "Limit of Liability" was stated as follows:

> "LIMIT OF LIABILITY:
>
> GBP10,000,000 or its equivalent in other currencies each and every Claim including Claims Expenses for claims emanating from or brought anywhere in the world excluding USA, its territories or possessions, or Canada.
>
> ONLY TO PAY EXCESS OF
>
> USD 20,000,000 any one claim and in the annual aggregate emanating from or brought anywhere in the world (including Claims Expenses)
>
> ONLY TO PAY EXCESS OF
>
> USD 30,000,000 any one claim and in the annual aggregate emanating from or brought anywhere in the world (including Claims Expenses)
>
> ONLY TO PAY EXCESS OF
>
> USD 5,000,000 any one claim and in the annual aggregate emanating from or brought anywhere in the world (including Claims Expenses)
>
> ONLY TO PAY EXCESS OF
>
> USD 5,000,000 any one claim and in the annual aggregate emanating from or brought anywhere in the world (including Claims Expenses)
>
> ONLY TO PAY EXCESS OF A RETENTION OF:
>
> USD 10,000,000 any one claim (including Claims Expenses) for Claims emanating from or brought anywhere in the world."

27. The "Conditions" in the Excess Policy stated that "Underwriters hereon acknowledge that the underlying can be eroded by losses emanating from USA/Canada operations".

28. The Excess Policy included these "General Conditions for Facultative Business":

> "…
>
> A. REINSURING CLAUSE
>
> Except as otherwise agreed, the Reinsurer's liability under this Agreement shall follow that of the Reinsured for losses under all terms,

conditions and limits to the Reinsured's Original Policy or Policies specified therein …

E. NOTICE OF LOSS
It is a condition precedent to the Reinsurer's liability that the Reinsured shall give immediate written notice of any claim or loss under this Policy which is likely to affect this Agreement as set out below. ... Furthermore, the Reinsured shall immediately advise the Reinsurer of any subsequent material developments in connection with any claim or loss. …

F CLAIMS & SETTLEMENTS
The Reinsured shall properly and thoroughly investigate any claim or loss and, to the extent required by the Policy, defend and/or control any claim or loss that affects this Agreement. However, the Reinsured shall not without consulting the Reinsurer or its representative litigate any such claim. It is a condition precedent to any liability of the Reinsurer that the Reinsured shall fully co-operate with and shall actively take steps to involve the Reinsurer or any person designated by the Reinsurer in the adjustment and settlement of, as well as permit the Reinsurer at its own expense to associate with the Reinsured in the investigation, defence, and/or control of any claim or loss that may affect this Agreement. It is a condition precedent to any liability of the Reinsurer for any settlement that the Reinsured may make with respect to the Policy that the Reinsured first obtain the Reinsurer's written consent to the settlement.

G LOSS PAYMENT
Upon receipt of a definitive statement of loss, the Reinsurer shall promptly pay its proportion of such loss."

29. By way of "Information", the slip stated:

> "Underlying impairment to be monitored by McCullough, Campbell & Lane who to produce a biannual review of all claims, including Bordereaux showing paid and outstanding claims from the ground up …".

McCullough, Campbell & Lane ("MCL") are American lawyers, who are, as I understand it, instructed to monitor impairment in relation to professional liability claims made against BV by interested insurers and reinsurers other than the defendants.

The underlying legal principles

30. In view of the arguments developed by the parties, I shall first, before coming to the specific wordings that govern this dispute, state what I consider to be established legal principles relevant to the liability of reinsurers.

i) Reinsurance is not insurance of an insurer's liability to the original insured but of the same risk as the original insurance, in which the insurer has an insurable interest because of his exposure under the original insurance: Delver v Barnes,

(1807) Taunt 48,51 per Mansfield CJ; Wasa International Insurance Co v Lexington Insurance Co, [2009] UKHL 40, para 33 per Lord Mance. Hence, the reinsurers' liability arises fundamentally from loss suffered by the original insured, not from insurers' liability in respect of that loss.

ii) Subject to any relevant terms of the (re)insurance contract, the right of an insured to an indemnity arises when an insured loss is suffered In the case of liability cover the application of this principle is that a loss is suffered when liability is established and the amount of liability has been ascertained, whether by action or arbitration or by settlement, and not earlier: Post Office v Norwich Union Fire Insurance Society Ltd, [1967] QB 363, Bradley v Eagle Star Insurance Co Ltd, [1989] AC 957.

iii) In the case of reinsurance, the right of the reinsured to an indemnity arises once his own liability to the original insured has been ascertained and quantified in legal proceedings, by arbitration or by agreement. It does not (in the absence of contrary agreement) depend upon the reinsured paying the original insured: Versichaerungs und Transport A/G Dauvaga v Henderson, (1934) 49 Ll LLR 252, MacGillivray on Insurance Law (2008) 11th Ed para 33-072.

The Defendants' case

31. On the basis of these propositions, Mr Colin Edelman QC, who represented the defendants, submitted that, subject to the agreed deductibles and BV's SIR, BV's losses erode the p.i. tower in the order in which they are suffered by BV, and that the question whether the excess point under the Excess Policy has been reached, so that the Excess Policy responds to a particular loss, depends upon whether the layers of the p.i. tower are sufficient to cover the loss, taking into account whether and how far they have been eroded by losses which BV had previously suffered. Thus, he argued, unless and until a loss has already been suffered by BV, it is not brought into account for the purpose of determining whether the layers of the p.i. tower are exhausted, and the question whether a loss has already been suffered by BV depends in the case of the liability cover provided by the p.i. tower upon whether BV's liability has been established and ascertained in amount, and in the case of the mitigation cover upon when BV incurred the costs and expenses.

32. In support of this submission, Mr Edelman cited the judgment of Timothy Walker J in North Atlantic Insurance Co Ltd v Bishopsgate Insurance Ltd, [1998] 1 Lloyd's Rep 459. The issue in that case was how it was to be determined whether the excess point under an aggregate excess of loss reinsurance had been reached, and more specifically whether it was to be determined by reference to when the reinsured's liability to pay the inward claim was established or by reference to when the reinsured paid the claim. Timothy Walker J said that "Since in principle the cause of action of the reinsured is complete when liability is established, in my judgment the [date that the reinsured's liability to pay the inward claim is established] must be the date to take".

Teal's arguments

33. Mr ter Haar disputed the submission that BV's insurers in the p.i. tower became liable in respect of the mitigation losses when BV incurred costs and expenses in remedying

design defects, and argued that they have no liability unless and until they were asked to pay. The general rule, however, is that, unless the position is affected by the terms of the insurance, a cause of action against an insurer arises when the insured loss or other event occurs, and it is not delayed because no claim or notification has been given to the insurer: Halsbury's Laws of England, Vol. 25, 4th Ed, 2003 Reissue, para 184. Although Mr ter Haar submitted that this principle does not comfortably apply when mitigation costs are covered by a policy which essentially provides liability cover on a claims made and reported basis, I see no reason that the basis of liability cover should affect when the insurers become liable for mitigation costs. Of course, as Mr ter Haar submitted, in some circumstances detailed analysis would be required about when costs were incurred, but this is not sufficient reason to depart from the general rule. I accept Mr Edelman's submission about when insurers' liability for mitigation costs would arise, subject to what I shall call the clause 1 submission, to which I refer below.

34. Mr ter Haar developed three other arguments in his oral submissions:

i) First, he submitted that the question whether losses have eroded the p.i. tower depends upon when Teal became liable to pay for them under the Original Policy, and that because of clause 1 in the Original Policy they are not liable to pay BV until the condition stated in the clause is satisfied. I shall call this the "clause 1 submission".

ii) Alternatively, he submitted that the question whether the defendants are liable under the Excess Policy in respect of a particular loss does not depend upon the order or timing of that loss, or of liability in respect of it, in relation to other losses or liabilities, but upon the level of aggregate losses in the relevant period. If (American or non-American) claims exhaust and exceed the p.i. tower in aggregate, the Original Policy and so the Excess Policy cover any excess over the p.i. tower if and to the extent that the aggregate includes losses in respect of non-American claims. I shall call this the "annual aggregate submission".

iii) In the further alternative, Mr ter Haar submitted that, if liability under the Excess Policy in respect of a particular loss does depend upon its "order" in relation to other losses, the order is determined by when it was notified by BV to their insurers. I shall call this the "notification submission".

<u>The clause 1 submission</u>

35. The clause 1 submission seeks to answer the defendants' contention by confession and avoidance. It is argued that, whatever might be the prima facie position about when an insurer becomes liable to indemnify his insured, the effect of clause 1 of the Original Policy (and indeed the Intermediate Policies) is that Teal are not liable to pay BV unless and until Lexington and Teal have paid the full amount of the underlying layers in the p.i. tower or have admitted their liability to do so or have been held to be liable to do so. On the facts of this case, as Teal contend, this condition has not been satisfied with regard to either the Ajman Sewerage Plant claim or the PPGP facility claim and so they are not liable to pay anything in respect of these claims under the Original Policy (or the Intermediate Policies). Because of clause 1, their liability did not arise when the losses occurred, and so the proper application of the principle

recognised by Timothy Walker J is that the order in which claims erode the p.i. tower is determined not by reference to when the losses occurred but rather by reference to when clause 1 is satisfied in relation to them.

36. Mr Edelman's response to the clause 1 submission is that this interpretation distorts the purpose of the clause and gives it an effect that it was not intended to have and that it cannot properly be given. It is necessary in policies of excess insurance to stipulate when the losses reach a level at which the excess layer attaches. One way of doing so is to require the insured to show an ultimate net loss sufficiently large to exceed the excess point and to penetrate the excess layer. The alternative approach, adopted in "top and drop" policies such as Teal's Original Policy, is to stipulate that there is no obligation to pay unless and until lower layers are exhausted, in which event, as provided in the drop clause of the Original Policy, the layer will drop down to replace the exhausted cover beneath it. Clause 1 is a necessary (or at least a readily understandable) part of the machinery when this "top and drop" approach is adopted: for example, the insured might make a claim which would exhaust the lower layer(s) but which the underlying insurers dispute on the grounds that the insurance does not cover it. If the insured then suffers another loss which he presents to the excess layer insurers, clause 1 allows them to respond that they would accept the claim assuming that the insured is right that the lower cover is exhausted by the earlier claim, but if the underlying insurers have a good answer to it, then they and not the excess layer insurers are liable for the second claim.

37. I agree that this is the effect and purpose of clause 1, and I reject Teal's clause 1 submission. In substance, if not in form, clause 1 operates, as Mr Edelman put it, simply to impose a pre-condition to the Original Policy responding to a claim. The effect of this is that, because the defendants are not liable to pay under the Excess Policy until Teal are liable to pay under the Original Policy, therefore the defendants are not liable to pay under the Excess Policy until the condition precedent in the Original Policy is satisfied. However, I cannot accept the parties to the Original Policy intended a pre-condition of this kind to liability under the Original Policy to affect the order in which losses are to be taken to erode or exhaust the p.i. tower for the purposes of determining whether the Original Policy responds to a particular claim; and, more importantly, I cannot accept that the parties to the Excess Policy intended that this should determine which claims are covered by the Excess Policy. In other words, where there is a programme of top and drop policies of this kind, the criterion that determines the order in which losses erode the p.i. tower is not when the insurer is liable under the original policy but when liability arises under the original insurance programme, including the underlying cover: that is to say in this case, including the p.i. tower as well as the Original Policy.

38. I do not consider that the decision in the North Atlantic Insurance case is inconsistent with this reasoning. Timothy Walker J. was concerned only with whether the order of claims depended upon when the original insurers incurred liability or upon when they paid. As the effect of the decision is summarised in MacGillivray on Insurance Law (cit sup) para 33-72 fn 258, "in excess of loss reinsurance, the reaching of the excess point was determined by reference to the date that the reinsured's liability to pay over the excess was established".

39. Mr Edelman sought further support for the defendants' contention as to the operation of BV's cover and the Excess Policy in clause 4 and in clause 5. I do not consider

that he needs these further arguments, and in my judgment they do not significantly strengthen his case.

40. He made two submissions about clause 4: first, he argued that the expression "may be liable", rather than "is liable", is used in the first sentence because the policies contemplate that, at the time that costs might be incurred, there might well be uncertainty about whether the insurers are liable under them, not only because the amount of the claim might not then be known, but also because there might be two substantial claims pending and it is not known which will be ascertained and established first. It is said that the second uncertainty reflects that the parties' intention that priority of claims depends upon the order in which they were established or ascertained. I reject that argument: the use of the expression "may be liable" is fully explained by the likelihood that the amount of a claim will be uncertain when it is first made.

41. Mr Edelman's second argument about clause 4 is based on the second sentence, and in particular the expression "such a sum as *will* involve this Policy" (emphasis added). It is submitted that this indicates that, at the time of a settlement of a claim against BV, both BV and Teal will know whether it is covered by the Original Policy (or, as the case might be, one of the Intermediate Policies). This will be so, he submitted, if the priority of the claim in relation to other claims depends upon the settlement itself and when it is made, but not if it depends upon when the conditions of clause 1 are satisfied.

42. I do not see much force in this argument. I recognise that the wording of clause 4 fits comfortably with the defendants' contention as far as the Original Policy provides liability cover, but it could hardly be expected that Teal would know precisely at any particular time how far underlying policies had been eroded by liability for mitigation cover. More importantly, the argument places weight upon the precise wording of clause 4, and the wording of the Original Policy does not indicate it was drafted as meticulously as the argument suggests. In any case, as Mr ter Haar pointed out, it will generally be known by the time that a claim is settled what liability has arisen under clause 1 in respect of other claims.

43. Mr Edelman's submission with regard to clause 5 was that it provided for immediate notification if a claim or loss appeared likely to exceed the underlying cover because Teal were in turn obliged under General Condition E of the Excess Policy to give immediate notice to the defendants. He argued that this clause too contemplates that the underlying policies will be progressively eroded and is consistent with the defendants' contention. I accept that it is so consistent, but it does not answer the clause 1 submission.

44. I add that the clause 1 submission led to some exchanges between counsel about how far Teal (and BV) would be entitled to arrange the timing and order of payments under underlying layers in order to maximise their reinsurance recoveries. Mr ter Haar submitted that they are entitled to deal with claims so as to maximise their recovery under their reinsurance, and under no obligation to minimise the liability of the reinsurers: that they were "free to deal with claims in whatever order they wish"; or that they were "free to do whatever was in their business interests". Mr Edelman disputed this: he said that Teal's room for manoeuvre is restricted by their obligations arising from the claims co-operation clause (see Gan Insurance Co Ltd v Tai Ping

Insurance Co Ltd (Nos 2 and 3), [2001] Lloyd's LR (I & R) 667 at para 72 per Mance LJ), and in any case they would not be entitled to act arbitrarily, capriciously or unreasonably (see Abu Dhabi National Tanker Co v Product Star Shipping Co Ltd, [1993] 1 Lloyd's Rep 397 at p.404 per Leggatt LJ). Since I reject the clause 1 submission, I do not need to consider whether Teal would be free to arrange their affairs as Mr ter Haar suggested, but, to my mind, this discussion illustrates the uncertainty that would be introduced into the reinsurance arrangements if the clause 1 submission were correct, and makes it the less likely that the parties intended clause 1 to affect the question of which losses go to erode the p.i. tower.

The annual aggregate submission

45. I also reject the annual aggregation submission. "Top and drop" policy, such as the Intermediate Policies and the Original Policy, do not usually operate on the basis that, after the end of the insurance period, the insured will aggregate the total of his losses and attribute different losses to different policies without regard to when in the period of the insurance they were incurred. As Mr Edelman observed, where, as here, insurance is on a claims made and reported basis, a claim might not be made against the original insured for many years after notification of circumstances is received, and the full losses could not be reliably aggregated at the end of the year or for a long time thereafter. If an insurance programme were to be placed on the basis contemplated by the annual aggregation submission, clear wording to this effect would be required, and there is none in the policies with which I am concerned. On the contrary, they contemplate that the layers of cover in BV's programme will be eroded during the course of the policy period. Hence the "drop provision" in the Intermediate Policies and the "Original Policy" states that, if cover on the underlying layers is reduced, then, if the erosion is partial, the reduced cover shall apply "for the remainder of the period of insurance", and, if it is total, the policy "shall continue in force as Underlying Policy until expiry hereof".

The notification submission

46. As I understand the notification submission, it depends upon a contention that the market operates on the basis that cover is eroded successively by claims according to when the insured notifies them to his insurers. Mr ter Haar did not argue that it is justified by the wording of the Excess Policy or other policies with which I am concerned, and no evidence of market practice was adduced. I reject the notification submission.

47. I add that Mr ter Haar did not develop Teal's pleaded contention that "the Excess Policy responds to claims having regard to the order in which claims are actually paid by" Teal. He also abandoned in his oral submissions the suggestion in his written submission that "An alternative approach is to examine the exhaustion of the [p.i.] tower from the viewpoint of the reporting lawyer, Mr Frostic of MCL". I need only say that I reject those suggestions. The former was rightly rejected by Timothy Walker J in North Atlantic Insurance Co Ltd v Bishopsgate Insurance Ltd (cit sup) for the reasons that he gave, and I can see no principled basis for adopting the latter.

Conclusion

48. I therefore reject the various submissions advanced by Teal and accept the contention of the defendants about the operation of the Excess Policy. I shall invite submissions as to the precise order that I should make in light of this conclusion.