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# E-ALERT | Insurance

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# ENGLISH COURT OF APPEAL DENIES COVERAGE FOR SETTLEMENTS AND DEFENCE COSTS TO POLICYHOLDERS WHO DO NOT PROVE ACTUAL LIABILITY IN UNDERLYING LITIGATION

## Introduction

In a decision with significant implications for policyholders holding liability policies governed by English law, the Court of Appeal in England has held that a policyholder must prove its actual liability to a third-party claimant in order to recover insurance proceeds covering the amount of any settlement with the third party and the costs of defending the third party's claims.

The decision in ***AstraZeneca Insurance Company Limited v. XL Insurance (Bermuda) Limited***, handed down on December 20, 2013, concerned a modified "Bermuda Form" policy governed by English law, rather than New York law, as is more usual. If the decision is not reversed by the UK Supreme Court, it could have ramifications for many liability policies governed by English law. The case is of particular concern to corporate insureds holding such policies who incur significant defence costs defending third-party claims but settle those claims before trial or final judgment.

## Background

The claimant policyholder, AstraZeneca Insurance Company Limited ("AZICO"), is the captive insurer of the AstraZeneca Group. It claimed an indemnity from its reinsurers, after having paid its AstraZeneca Group policyholder for settlements and defence costs it had incurred in connection with underlying mass tort litigation in the US concerning a pharmaceutical product. Two questions were tried as preliminary issues:

1. Did the underlying policyholder have to prove that it would have been actually liable to a third-party claimant in order to be entitled to an indemnity against sums it had paid in settlement of the claim?

2. Was the underlying policyholder entitled to indemnity under the policy in respect of defence costs only if it proved that it would have been liable to the third-party claimants?

The parties agreed that the Court must interpret the underlying direct insurance policy between AZICO and its policyholders in order to determine those issues.

## The First Instance Court's Decision

In the court of first instance, Mr. Justice Flaux held as to the first preliminary issue that the policyholder must prove that it would have been liable to the third-party claimant in order to recover from its insurers any amounts paid in settlement. Although the Bermuda Form is typically governed by New York law, he was not prepared to give any weight to New York legal authorities: he concluded that English case law authority at first instance and appellate levels supported his conclusion, and held that the wording of the policy itself did not assist the policyholder.

In relation to the second preliminary issue, Mr. Justice Flaux held that a policyholder could only recover defence costs under the policy if it could prove that it was actually liable to the third-party claimant. The judge's decision on this issue was relatively brief and was based of his interpretation of the specific policy wording, backed by his holding on the first preliminary issue.

## The Decision of the Court of Appeal - Settlements

The Court of Appeal agreed that an English Court should not take New York law into account in interpreting the policy. It upheld Mr. Justice Flaux's conclusion that, as a general proposition of English law, liability policies are understood to require that "actual liability" be established and held that "in order to recover from his insurer the insured must show that he was liable to the person who claimed against him." The appellate court also rejected the argument that the policy language at issue gave the policyholder the right to an indemnity for settlement amounts paid to third parties, absent proof of actual liability.

## The Decision of the Court of Appeal - Defence Costs

The Court of Appeal noted that there is no general right to recover defence costs under liability policies governed by English law and that, in the absence of a duty to defend, any entitlement to recover defence costs must be based on a free-standing entitlement under the policy.

The Court also characterized the policy as having been badly drafted, since defence costs could not be recovered on a literal reading of the policy: consequently the only way in which defence costs could be recovered under the policy would be as "parasitical on" damages, and (per the Court's holding on the first question) the policyholder must prove actual liability in order to recover them. The Court was not prepared to go beyond its understanding of the specific wording of the contract and hold defence costs to be recoverable.

The Court of Appeal refused the policyholder permission to appeal to the UK Supreme Court on both issues, although it is open to the policyholder to seek permission to appeal from the Supreme Court itself.

## Discussion

The Court of Appeal recognised that its application of English law resulted in a policy interpretation highly unfavourable to the policyholder. Indeed, under New York law, which governs most Bermuda form policies, the result should be quite different. In the United States, a policyholder that chooses to settle to avoid the staggering costs of tort litigation and to mitigate against the risk of an adverse verdict would not be expected to prove that it would in fact have been liable to a third-party claimant as a predicate to securing insurance coverage.

The Court of Appeal acknowledged that the principle that the policyholder cannot recover unless it can prove that it was in fact liable to the underlying third party tort claimant is "potentially very inconvenient for insureds," since the insurer has no incentive to assist with the defence of, or pay, a claim, and may even require a policyholder to prove liability again in an insurance recovery action even where it has already been adjudged liable to a third party by a court or tribunal. But the Court was not prepared to remedy these injustices through judicial interpretation, and considered that the parties could only redress the balance by reaching differently worded agreements in the future -- a consideration that would not help those policyholders with existing policies governed by English law that are similar to the one at issue here. The Court reached its conclusion despite observing that the policy had to be interpreted in its commercial context, having regard to the circumstances that were or should have been apparent to reasonable persons in the position of the parties. It did not, however, explain why reasonable persons in a commercial context would have intended to discourage both the vigorous defence and the

settlement of third-party claims, by requiring proof of actual liability as a condition of coverage for both defence and settlement costs.

## Implications for Policyholders

If the decision of the Court of Appeal is not overturned by the Supreme Court, policyholders holding English law policies who have proceeded on the basis that defence costs and settlement payments will be covered in cases where they dispute liability may find that:

- those costs, any settlements entered into, and possibly even any sums paid pursuant to court judgments, are in fact not covered absent policy language specifying a different result;
- insurers under policies that do not contain a duty to defend may increasingly stand back and allow their policyholders to incur defence costs and pay settlements which they will then claim are not recoverable under the policy;
- policyholders may be limited to recovering defence costs and payments to third parties only in cases that they actually lose or where they are willing to prove that they would have lost, even though they would be required by insurers to defend these cases to the best of their ability and deny liability (i.e., the ruling creates a perverse incentive: a policyholder forfeits coverage if it successfully defends the claim, but may still obtain coverage if the defence is unsuccessful); and
- policyholders that successfully defend claims in jurisdictions where a proportion of their costs are recoverable from the claimant may be unable to obtain payment by insurers of the proportion of their costs that they are unable to recover from the claimant.

Going forward, policyholders should pay special attention to the governing law of any new policy into which they enter. Particularly if a policyholder agrees to English law as the law governing a liability policy, it should ensure that the wording of the policy specifically permits it to recover indemnities from its insurers in respect of defence costs and settlement payments where liability is merely alleged, without the need to prove actual liability. Indeed, any policyholder using the Bermuda form may consider carefully the wording of its policies and alternate language or coverage vehicles to foreclose the possibility that it will face the sorts of arguments advanced by the reinsurers in ***AstraZeneca***. This is particularly so for those policyholders facing litigation in the United States, where it is often prudent to settle litigation to avoid the costs and risks of litigation and where admissions of actual (as opposed to risk of potential) liability may not only be counterfactual but also invite additional litigation.

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