CA on appeal from QBD (Gavin Healey QC sitting as a Deputy High Court Judge) before Peter Givson LJ, Tuckey LJ, Sir Martin Nourse. 6th April 2004.

JUDGMENT : Lord Justice Tuckey:

1. This is an appeal about the meaning and effect of a follow the settlements clause in a reinsurance contract. In ***The Insurance Co. of Africa v Scor (UK) Reinsurance Co. Ltd.*** [1985] 1 Lloyd's Rep. 312 at page 330 Robert Goff L.J. said*: In my judgment the effect of a clause binding reinsurers to follow settlements of the insurers, is that the insurers agree to indemnify insurers in the event that they settle a claim by their assured, i.e., when they dispose, or bind themselves to dispose, of a claim, whether by reason of admission or compromise provided [1] that the claim so recognised by them falls within the risks covered by the policy of reinsurance as a matter of law, and provided [2] also that in settling the claim the insurers have acted honestly and have taken all proper and business like steps in making the settlement.*

This well-known passage was considered to have resolved earlier controversy about the meaning of such standard form clauses. The appeal however raises two questions:

(i) to what extent does the first proviso preclude reinsurers from raising coverage issues relating to terms which are the same in both the insurance and the reinsurance contracts? and

(ii) does the addition of the words "without question" add anything to the meaning and effect of the clause in this case?

2. The appeal is from a decision of Mr Gavin Kealey Q.C. sitting as a Deputy High Court Judge in the Commercial Court. His judgment, from which he gave permission to appeal, is reported at [2003] EWHC 1073 (Comm.) and in [2003] Lloyd's Rep. IR 725. The judge gave a very full answer to the first question and answered the second question in the negative. The claimants, Generali, say that both answers are wrong.

3. The facts are very fully set out in the judge's judgment to which reference can be made if necessary. For present purposes however I can summarise them shortly.

4. The original cover was provided by a Canadian company (CIC) as a front for Generali. Nothing turns on the fronting arrangement. The insurance covered contractors risks for the installation and maintenance of power cables to be laid under the St. Lawrence river. About a year after they had been laid one of the cables suffered a loss of phase which was later found to be caused by abrasion of the cable on the river-bed. A repair was attempted but in due course the cables were replaced. When the claim under the insurance was made a variety of coverage issues arose which included whether the claim was for unforeseen and sudden physical loss, whether the proximate cause of the loss was faulty design, bad workmanship and/or wear and tear and whether there was one or more than one loss. After protracted negotiations Generali settled the claim for $4m.

5. Generali reinsured 80% of its liability with the defendant companies and a number of Lloyd's syndicates who had subscribed to a broker's open cover. The reinsurance was: *As original: Anything herein to the contrary notwithstanding, this Reinsurance is declared and agreed to be subject to the same terms, clauses and conditions, special or otherwise, as the original policy or policies and is to pay as may be paid thereon and to follow without question the settlements of the Reassured except ex-gratia and/or without prejudice settlements.*

The Lloyd's market paid its share of Generali's claim on the reinsurance. The defendants refused to pay theirs. Their defence relies on both the **Scor** provisos. Generali contend that the decision in Scor and the wording of this follow the settlements clause mean that the defendants cannot rely on either proviso. To the extent that Generali are wrong about this, however, they accept that there are issues on the merits which can only be resolved at trial.

6. Generali's application before the judge was for summary judgment for the amount of their claim. However, when it became apparent in the course of the hearing that this application would fail the judge was persuaded to resolve summarily the issues of construction of the follow the settlements clause. So far as is material to this appeal the judge made a declaration that*: The defendants are bound by all settlements made by Generali (except **ex-gratia** and without prejudice settlements)*

(a) Provided that the claims so recognised by Generali fall within the risks covered by the contract of reinsurance as a matter of law (by which is meant, provided that the claims were settled on a basis which, if and assuming it to be valid, falls within the risks covered by Generali's outward contract of reinsurance as a matter of law); and

(b) Provided that Generali acted honestly and took all proper and businesslike steps in making such settlements.

7. Generali's primary case before the judge was that the words "without question" precluded the defendants from relying on either of the Scor provisos. Their secondary construction was that these words at least precluded reliance on the second proviso. What they called their "tertiary" construction was broadly accepted by the judge. In doing so he rejected the defendants' contention, which is no longer pursued, that Generali had to establish that the loss fell both within the risks covered by the insurance and within the risks covered by the reinsurance as a matter of law. Generali's submissions only made it necessary for the judge to consider the meaning of the words "without question". The defendants' submission, however, did involve consideration of what the first proviso means, particularly where the insurance and the reinsurance are back to back. It is still necessary to consider what the first proviso means because of the way Generali put their case on appeal. They now accept that the words "without question" do not preclude reliance on the first proviso. What they say instead is that the first proviso itself precludes reinsurers from raising coverage issues where the insurance and the reinsurance are on back to back terms: once those issues are settled by the insurers with their assured, that settlement is binding on reinsurers who cannot raise the same coverage issues in defence of the claim on the reinsurance; any defence is confined to terms peculiar to the reinsurance.

8. The judge started by reminding himself of what Lord Mustill said in ***Hill v Mercantile and General Reinsurance Co. Plc*** [1996] 1 WLR 1239 at page 1251: *There are only two rules, and both obvious. First, that the reinsurer cannot be held liable unless the loss falls within the cover of the policy reinsured and within the cover created by the reinsurance. Second, that the parties are free to agree on ways of proving whether these requirements are satisfied.*

Follow the settlement clauses are an expression of the second rule. ***Scor*** *established that the standard form of such a clause relieved insurers of the obligation to prove that the loss fell within the original cover, both as to liability and amount (para. 35). But the words did not themselves relieve the insurers of their obligation to prove that the loss fell within the cover created by the reinsurance. They did however have an impact on how that loss could be proved in the way Goff L.J. explained. The insured did not have to prove that the original loss fell within the risks covered by the reinsurance, but rather that the claim so recognised by them falls within the risks covered by the policy of reinsurance as a matter of law* (para. 36).

9. These conclusions did not mean that where the contracts are back to back any proper and business-like settlement by the insured dictated that they were entitled to an indemnity from their reinsurers. If the claim recognised by the insurers did not fall within the risks insured against as a matter of law it would follow that it was not covered by the reinsurance and so would be irrecoverable, even if the second proviso did not apply (para. 42). The judge then gave examples to explain this conclusion (paras. 43 and 44) including reference to the decision of Evans J. in ***Hiscox v Outhwaite (No. 3)*** [1991] 2 Lloyd's Rep. 524 with which the judge agreed (paras. 51 and 56). This case, to which I shall refer later, supported the judge's conclusions which I have summarised and added a possible gloss to them.

10. As to the meaning and effect of the words 'without question' the judge said: *The reinsurers (the defendants) assumed the obligation "to follow without question the settlements of the reassured except ex-gratia and/or 'without prejudice' settlements". The words 'without question' do not describe or qualify what the defendants have agreed to follow, namely Generali's settlements, but rather how or the manner in which they are required to follow those settlements. It is made emphatic in my view that, subject to the two Scor provisos as explained above, the defendants have to follow, without challenge, Generali's settlements except those falling within the two identified categories. Those excepted categories comprise settlements of claims made either on the basis that Generali had no legal liability to make them or on the basis that liability was not admitted. It seems to me the nature of the excepted categories of settlement informs the context against which the undertaking not to question is to be understood. The concentration of those excepted categories on a recognition (express or implicit) by Generali of the absence or non- acceptance of legal liability as the basis of a settlement indicates that the*

settlements that the defendants have bound themselves to follow include those by which Generali has compromised any issues arising as to its legal liability, or has admitted liability, to its own assured even though, if there had been a trial of the issues, it might have been proved that Generali had no actual liability. I do not consider that the words 'without question' mean that the defendants have agreed to relieve Generali of its important implied obligation in relation to any compromise of liability or amount to take all proper and business-like steps in making the settlement. On the contrary, in circumstances where, as I find, the defendants have so significantly entrusted their interests to Generali, the implied obligation assumes an even greater significance than it might otherwise possess. If the defendants were to be deprived of the protection that it offers, far clearer and more explicit words would be required. It seems to me that those words were used on the assumption that all such proper and business-like steps would be taken and, in their context, serve to emphasise that, subject to the two provisos identified by Robert Goff L.J. as explained further by Evans J. in a case where the reinsurances and the insurance are consciously back to back, reinsurers have agreed to be bound by an admission or compromise of liability by the insurers on those terms and conditions as much under the insurance as under the reinsurance. (Para. 54)

11. Mr Hofmeyr Q.C. for Generali prefaced his submissions by inviting us to consider the philosophy behind follow the settlements clauses. He said this was to avoid multiple claims enquiries, to simplify and hasten claims procedures and to reduce the possibility of dispute between insurers and reinsurers. This is true, but as Lord Mustill pointed out in *Hill* there was an impulse acting in the opposite direction. This was to ensure that the integrity of the reinsurer's bargain was not eroded by an agreement over which he had no control. I do not think therefore that philosophy compels any particular solution. This depends upon the wording of the clause which the parties have agreed.

12. Mr Hofmeyr's submission on the first question is simple. He says that because the reinsurer was bound to accept any settlement made between the insurer and his assured he was liable under the reinsurance where the terms of the two contracts were back to back, provided that the insurers had acted honestly and taken all proper and business-like steps in settling the claim and, on the wording in this case, provided that the settlement was not ex gratia or without prejudice. Mr Hofmeyr submits that this is the effect of ***Scor.*** It is supported by a decision of the Hong Kong Court of Appeal in ***Insurance Co. of the State of Pennsylvania v Grand Union Insurance*** [1990] 1 Lloyd's Rep. 208 and, to the extent that it is against him, Mr Hofmeyr submits that ***Hiscox v Outhwaite*** is wrong.

13. This is a bold submission. It means that in a case where the insurance and reinsurance are back to back when defining the first proviso Robert Goff L.J. only intended to refer to coverage issues which were unique to the reinsurance. That is unlikely in view of the way he expressed the proviso and the fact that the reinsurance in **Scor** was "*as original*". It is also not the way the first proviso has been interpreted in practice or applied in other cases. Thus in ***Charman v Guardian Royal Exchange Assurance Plc*** [1992] 2 Lloyd's Rep. 607 Webster J. proceeded on the basis that the insurer could recover *"where the claim settled falls within the ambit of the risks covered by the reinsurance policy",* and in ***Baker v Black Sea and Baltic General Insurance Co. Ltd.*** [1995] Lloyd's Rep. IR 261, 283 Potter J. said *"the reinsurer is not liable if the claim settled does not fall within the risks covered by the policy of reinsurance as a matter of law"*. In both these cases the insurance and the reinsurance were back to back.

14. In ***Grand Union*** again the insurance and reinsurance were on the same terms. The reinsurers argued that the insurers had to prove that they were liable to pay on the original cover. After referring to Scor, Mortimer J. said of the first proviso that the reinsurer could only challenge the settlement if it was not within the reinsurance: *for he cannot seek to rip up the settlement and show that claims were paid for which the insured was not liable… he cannot seek to avoid liability simply by seeking to rip up the settlement by showing that in fact and only in fact that the insurer could have defeated the claim.*

It follows that when Lord Justice Robert Goff speaks of claims which fall within the policy of reinsurance he is referring to the terms of the policy of reinsurance and not the detailed terms of the original insurance incorporated therein. Were it otherwise he would be nullifying the conclusion to which he had already reached.

The Court of Appeal upheld the judge's decision. At page 223 Hunter J. A. said: *Two points I think, have to be noticed about the [Scor] provisos. The first, I have no doubt, was very carefully worded and*

*deliberately limited to the policy of reinsurance. Mr Collins argues that where, as is usual, the policy of reinsurance refers to the terms of the original insurance, the reinsurer can look through to those terms and complain, as was sought to be done here, of breaches of condition in the underlying policy. I reject that. If Goff L.J. meant that, he would in Mr Justice Mortimer's words "**be nullifying the conclusion that he already reached".** I am satisfied that he meant no such thing. He was well aware that many settlements include compromises on liability and quantum and that to permit reinsurers to go back to an alleged strict construction of the policy would destroy the value of the clause. If there is any question as to the sufficiency or propriety of the settlement it arises under the second proviso.*

15. I do not think that either of the judgments in ***Grand Union*** support Mr Hofmeyr's argument. They deal only with the position under the insurance. Before Scor it had been held in ***Excess Insurance Ltd. v Matthews*** [1925] 23 Ll. L. 71 and ***Scor*** confirmed that a follow the settlements clause precluded reinsurers from asserting that the insurers' settlement with the assured was not within the terms of the original policy either as to liability or amount. That is all ***Grand Union*** is saying. I do not read these judgments as saying anything about the effect of the clause on the reinsurance.

16. This question did arise in ***Hiscox v Outhwaite***. In that case a Lloyd's syndicate's whole account stop loss reinsurance was on terms which were agreed to be the equivalent of a follow the settlements clause. The question was whether the reinsurer was liable where the insurers, acting in a proper and business-like way, had made payments for which they were not legally liable under the Wellington agreement, a claims handling facility set up by producers and their insurers to deal with large numbers of asbestosis claims. Evans J. held that the reinsurers were not liable. After referring to the first proviso in Scor and the fact that its application gave rise to difficulty where the contracts were back to back he said at page 530: *In my judgment, the reinsurer is always entitled to raise issues as to the scope of the reinsurance contract, and where the risks are co-extensive with those of the underlying insurance he is not precluded from raising such issues, even when there is a "follow the settlement" term of the reinsurance contract. Ultimately, this is the only sure protection which the reinsurer has against being called upon to indemnify the reinsured against payments which were not legally due from him to the original insured, however reasonable and business-like the payments may have been. But this is subject to one proviso which I have already assumed in the syndicate's favour, and which is supported by the judgment of Hunter J.A. in the Grand Union case, quoted above. The reinsurer may well be bound to follow the insurer's settlement of a claim which arguably, as a matter of law, is within the scope of the original insurance, regardless of whether the court might hold, if the issue was fully argued before it, that as a matter of law the claim would have failed.*

17. The proviso to which Evans J. refers is that reinsurers are bound by reasonable compromises on liability and quantum between the insurers and their assured under the terms of the original policy. That, as I have already said, is well established: the insurer does not have to prove that if the original claim was fully argued it would in fact have succeeded. No investigation as to whether it was arguably within the terms of the original policy is required. But what Evans J. says about the reinsurance is clear. Like the judge, I agree with what he says.

18. What I have said so far disposes of Mr Hofmeyr's submissions on this part of the case which I do not accept. But none of the earlier cases have considered how the first proviso works in practice in a case such as this. Here the judge has done so. By reference to the words "the claim so recognised" he has concluded that the insurers do not have to show that the claim they have settled in fact fell within the risks covered by the reinsurance, but that the claim which they recognised did or arguably did. I think this gives effect to what Robert Goff L.J. said and gives some sensible added meaning to the clause. It gives substance to the fact that the reinsurer cannot require the insurer to prove that the assured's claim was in fact covered by the original policy, but requires him to show that the basis on which he settled it was one which fell within the terms of the reinsurance as a matter of law or arguably did so. This and the need for the insurer to have acted honestly and taken all reasonable and proper steps in settling the claim provide adequate protection for the reinsurer.

19. This is as much as it is necessary to say to decide the first question on this appeal and assist the parties to see what the issues will be at trial. In an effort to be helpful the judge embarked on what he accepted was a somewhat academic exercise and gave hypothetical examples to illustrate his

conclusions. With the benefit of hindsight I am not sure that I should have embarked on such an ambitious exercise. The judge was determining summarily issues of construction of the clause in question. I should have stuck to that task and left to this case at trial or other cases any wider statements of principle illustrated as necessary by the actual facts of the case. My approach to the appeal is governed by the same caution. The parties disputed the application of the judge's conclusions to the examples which he gave and I think it would be unwise for us to be drawn into controversy about the application of principle to hypothetical facts.

20. I can deal with the second question shortly. Mr Hofmeyr submitted that the parties could not have intended that the words "*without question*" were simply added for emphasis. The judge's construction gave them no or no sufficient meaning and ignored the context in which they were used. This was a contract between professional insurers who must be taken to have intended to cut down the Scor provisos which would have applied if the standard form had been used. It made sense that they should have agreed to forego the second proviso under a contract where the insurers retained 20% of the risk and so could be trusted to act prudently in their joint interests.

21. I do not accept these submissions largely for the reasons given by the judge. The cases show that the courts have not felt compelled to cut down the provisos where variants of the standard form have been used. Thus in ***Charman*** the clause contained the added words "liable or not liable". Webster J. said (at page 612) that the effect of the added words was to clarify rather than to qualify or limit the obligations of the insurer under an ordinary follow the settlements clause. In ***Hiscox v Outhwaite*** the clause made the insurers settlements "*in every respect …. unconditionally binding*", but the provisos were still held to apply. This is not to say that it would be impossible to draft a clause which excluded the second proviso, but clear words would be required to do so. The wording of the clause in this case does not make this clear. Nor does this particular reinsurance. 80% of the risk was reinsured, but Generali did not warrant that they would retain any part of it. Anyway the meaning of the clause cannot be dependent upon the extent of the insurers' retention. The open cover in this case required the clause to be incorporated into all reinsurances declared to the cover. It cannot have been intended to have had different meanings in different contracts bound on the same terms.

22. For these reasons I would dismiss the appeal.

Sir Martin Nourse: I agree

Lord Justice Peter Gibson: I also agree

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Sioban HEALY (instructed by Barlow Lyde & Gilbert) for the Respondents