

JUDGMENT : Gavin Kealey QC sitting as a Deputy High Court Judge : Commercial Court : 2nd May 2003

INTRODUCTION

1. There is before the Court an application dated 12th December 2002 by the Claimant, Assicurazioni Generali SpA ("Generali"), for summary judgment pursuant to CPR Part 24 against the seven Defendants. The Defendants are ILU reinsurers which, to the extent of their respective proportions, reinsured Generali under a contract of reinsurance contained in Declaration slip number 1 to a broker's open cover described as a "*Construction Risk Cover, Direct or Reinsurance*" to which the Defendants and Lloyd's syndicates subscribed. In the action, Generali claims as reassured sums that it asserts are due from the Defendants arising from a settlement concluded by Generali in relation to a claim under an original insurance policy issued by Continental Insurance Company ("CIC") to, among others, Pirelli Cables Inc. ("*Pirelli*") as original assured. Generali reinsured the cover issued by CIC 100%, CIC effectively fronting for Generali. Generali entered into the settlement in the sum of Canadian \$4 million. The Lloyd's syndicates, which also subscribed to the broker's open cover and reinsured Generali under the terms of the Declaration slip as co-reinsurers with the Defendants, approved the settlement and have paid to Generali their proportion of Generali's claim without dispute. The Lloyd's syndicates, therefore, are not parties to this action.
2. Generali's application for summary judgment is in two alternative parts. In the first part, Generali applies for judgment in the sum of Can\$2,291,123.20 plus interest and costs. In the second part, Generali applies for judgment on the true construction of the "*follow the settlements*" provision to be found in its contract of reinsurance with the Defendants. In its Application Notice, by reference to an attached draft order, it offers the Court three alternative meanings to be attributed to the follow the settlements provision, with each of which the Defendants disagree, and asks for summary judgment according to the preferential order in which those three alternatives have been set out. I shall turn to these three alternatives, to which Generali has referred elsewhere as its primary, secondary and tertiary constructions, in due course. It is perhaps sufficient to say at this stage that the first crucial issue between the parties is the proper construction of the follow the settlements provision.

THE FACTS

3. There is little significant dispute between the parties in relation to the essential background facts.
4. Pirelli was employed as contractor by Hydro Quebec to supply and install three single armoured high density submarine power cables between the north bank of the St Lawrence River and the Île aux Coudres in Quebec, Canada. On 24th February 1997, Pirelli approached Generali requesting a quotation for EAR cover for the project. In 1997, Generali had a relationship with CIC, partly embodied in a Canadian Quota Share Reinsurance Agreement effective from 1st January 1996, by which CIC agreed to front risks in Canada for Generali. As evidenced by a facsimile dated 15th May 1997 from Generali to CIC's agents, Lombard Insurance Company, Generali in due course received a firm order from Pirelli for EAR insurance cover and arranged that CIC should issue the original policy of insurance to Pirelli as a front for itself in consideration of a fronting fee of 11% of the premium. The policy issued by CIC provided cover for the project and named as assureds Hydro Quebec as principal and/or Pirelli as contractors and/or their sub-contractors and/or suppliers.
5. The cover provided by CIC as a front for Generali was "*works*" cover for the transportation, temporary storage, installation, testing and maintenance of the cables, and included a further "*Maintenance Guarantee*" period of 24 months from the date of "*taking over*". Under Section 1, Material Damage, the policy issued by CIC provided the assured with an indemnity "*if at any time during the period of cover the [cables] or any part thereof .. shall suffer any unforeseen and sudden physical loss or damage from any cause, other than those specifically excluded, in a manner necessitating repair or replacement ..*"

Among the Special Exclusions to the Material Damage protection were:

"(c) loss or damage due to faulty design, defective material or casting, bad workmanship other than faults in erection;

(d) wear and tear, corrosion, oxidation, incrustation."

Under Special Condition 2, it was provided that: "*Exclusion (c) to Section 1 of this Policy is abrogated in its entirety and it is expressly agreed that in respect of claims for loss or damage to the works where the cause is*

defective workmanship, material or design, the cover provided by the Policy shall include the cost of repair or replacement of insured items including rectification of such defective workmanship, material or design provided always that the property insured has been lost or damaged as a consequence of such defect. There shall however be no indemnity in respect of:

- a) the additional cost of introducing improvements or corrections in the rectification of the workmanship, material or design responsible for such loss or damage;*
- b) the deductible stated in the Schedule in respect of every such claim."*

Under Special Condition 3, there was a limited exception to Special Exclusion (d) in the following terms: *"Exclusion (d) of Section 1 is limited to the part of the items to be installed immediately affected and not to any consequences of such wear and tear, corrosion, oxidation or incrustation."*

The Maintenance Guarantee was contained in Special Condition 7 and this provided as follows: *"It is agreed that the cover granted under the General Conditions, General Exclusions, Special Conditions and Special Exclusions of this policy is extended to include Maintenance Guarantee for the period specified in the Schedule, to cover solely loss of or damage to the insured items, as per Section 1, resulting from faults in erection, faulty design, defective materials or casting and/or defective workmanship. ... The period of Maintenance Guarantee shall commence from the date of taking over indicated in the Taking Over or Provisional Acceptance Certificate and shall continue for a period of 24 months thereafter in respect of all insured items."*

The off-shore deductible in respect of Section 1 works was 10% of any claim amount, while the deductible in respect of maintenance was 20% of any claim amount.

6. As indicated above, CIC reinsured 100% of the risk to Generali. Article VI of the Canadian Quota Share Reinsurance Agreement which regulated the relationship between CIC and Generali provided in its first paragraph: *"The liability of the Reinsurer [Generali] shall follow that of the Company [CIC] in every case, and shall be subject in all respects to all the general and special stipulations, clauses, waivers and modifications of the Company's Policies, and any endorsements thereto."*
7. The cover for the Île de Coudres project was the subject of Declaration number 1 to the broker's open cover subscribed to by the Defendant Reinsurers. This Declaration provided as follows:
"TYPE: Construction Reinsurance.
.....
REASSURED: Assicurazioni Generali SpA
ORIG. ASSURED: Hydro Quebec, PCI, as principal and/or Societa Cavi Pirelli SpA and Pirelli Submarine Cables as Contractors and/or their sub-contractors and/or supplier as their respective interests may appear.
....
PERIOD: From date to be advised until 1st September 1997 as original. Extensions as original if required.
LOCATION: Canada or held covered as original.
INTEREST: Contract work for supply and installation of 3 28 KV EPR armoured power cables each 4.8 Km in length between the north bank of the St. Lawrence River and the Ile aux Coudres and 2,880 m on land cable cut into 15 sections.
SUM INSURED: Estimated Contract Value CAD 7,008,082.
CONDITIONS: 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.
Including deviation and/or change of voyage and/or extension of the original policy, as original.
.....
HERETO: 80%
PREMIUM: 2.5875% of FCV"
8. The Defendants and their co-reinsurers at Lloyd's thus reinsured Generali in respect of 80% of the risk for 2.5875% of the Full Contract Value. Generali has produced evidence that suggests that it retained the balance of 20% for its own account but there is no evidence that this was known to the Defendants at any material time.

9. The cables were installed by about 30th August 1997, whereupon the 24 month Maintenance Guarantee period commenced. On 30th August 1998, one of the cables suffered a loss of phase. This, it was later ascertained, arose from abrasion of the cable by friction against rock on the riverbed, to the extent that the internal conductor was exposed. On 21st September 1998, Generali was notified by Pirelli's brokers that Pirelli was making a claim in respect of the loss of phase.
10. By facsimile dated 24th September 1998, Pirelli asked Generali for an extension of the EAR policy to cover a proposed repair of the cable, which it said it needed before it would commence the repair work. By Generali's facsimile to its brokers dated 28th September 1998, which was then shown to the market, Generali notified the Defendants and reinsuring Lloyd's syndicates that damage had been sustained by one of the cables and that, whilst the actual amount of loss recoverable under the insurance had still to be ascertained, Pirelli estimated the total amount of the repairs at between Can\$750,000 and Can\$1,000,000. Generali also informed the Defendants and their co-reinsurers by the same communication that it had appointed Mr. Montgomery of Crawford-THG Toronto to assess the loss. On 7th October 1998, Generali sought and, on the following day obtained, an extension of its own reinsurance cover from the Defendants and reinsuring Lloyd's syndicates for the period 9th October to 1st December 1998 to cover examining the damage to, and the repair of, the damaged cable. The extension was contained in Endorsement number 5 and the sum insured was stated to be "Can \$1,000,000 and/or as original. (Deemed to be limit for above exposure)." On receiving the extension from its own reinsurers, by facsimile dated 8th October 1998 Generali notified Pirelli that it had confirmed to CIC's agents its agreement that CIC should extend the policy of insurance to cover the repair work. Generali invited Pirelli to contact CIC's agents' office in Toronto in order to obtain the requested certificate of insurance. According to Generali's original evidence, the extension of cover to the original policy was embodied in endorsement number 4 to that policy. However, the copy of that endorsement which appears in Generali's evidence contains no signature by CIC and no reference to any sum insured. More recently, Generali has produced a copy Certificate of Insurance signed by CIC on 9th October 1998 which extended the original policy for the period 9th October to 1st December 1998 in respect specifically of the cable repair work. However, that Certificate also contains no reference to any particular sum insured.
11. On 15th October 1998, Generali confirmed to CNA (on behalf of CIC) that all claims under the original policy would be handled by Generali directly with Crawford-THG Toronto, and that CIC's involvement was not necessary. This is explained in his witness statement by Mr. Zancola, a claims adjuster in Generali's Claims Department at its Central Head Office, on the basis that, because CIC had reinsured the risk 100% with Generali, it was normal for Generali to handle the investigation and adjustment of claims directly with the original assured.
12. Once the extension to the original cover had been confirmed, the repair operation began. The plan involved severing the cable on the river bed, raising the severed ends to a surface barge, cutting the ends back to sections of sound cable, splicing a replacement section of cable to the severed ends and, finally, lowering the repaired cable back to the river bed. It is not entirely clear what thereafter occurred. According to Generali, the cable was cut and the ends were raised to a barge on the surface but, after the repairs had commenced, on 6th November 1998 one cable end was lost to the sea and on 9th November 1998 one of the barge anchors failed causing the repaired joint of the other cable end to snap and that part of the cable also to be lost. However, according to some documents in the evidence relied on by the Defendants, it would appear that only one section of the cable (the South end) was raised to the surface, that it was successfully spliced to sound cable but that, when it was being lowered on 9th November, the barge unexpectedly moved and that section of the cable snapped at the joint. In any event, it appears to be common ground that, because of the onset of poor weather after 9th November 1998, the retrieval and repair operations were abandoned and ultimately, in July 2000, all three cables were replaced with a single 3-core cable stabilised by concrete mattresses.
13. In due course (there is a dispute about precisely when) Pirelli submitted its claim under the insurance. On 17th November 2000, Pirelli quantified its claim at Can\$4,738,604.99 net of policy deductibles on the basis of two occurrences: it stated that the first was when the cable originally failed, and that the

second was when the barge anchors failed and the cable broke and was lost. Thereafter there were discussions between Pirelli on the one part and Generali and Crawford-THG Toronto on the other part in relation to Pirelli's claim. The evidence suggests that a number of issues either occurred internally to Generali or arose in those parties' discussions. Those issues apparently included:

- (a) the number of losses: whether there had been one loss or two losses arising from two incidents; in particular whether the second incident on 9th November 1998 constituted a new event or accident which would have to be adjusted as a separate loss arising from a construction risk rather than under the Maintenance Guarantee;
 - (b) whether the loss or losses were unforeseen and sudden;
 - (c) whether the loss or losses were excluded by the exclusion of wear and tear in Special Exclusion (d) in Section 1 of the policy;
 - (d) whether the loss or losses resulted from a fault in erection, faulty design, defective materials or casting or defective workmanship within the meaning of the Maintenance Guarantee in Special Condition 7;
 - (e) if the second incident fell to be adjusted separately under the Maintenance Guarantee, whether the loss of or damage to the cable arising from that second incident resulted from a fault in erection, faulty design, defective materials or casting or defective workmanship;
 - (f) if the second incident did not fall to be adjusted separately under the Maintenance Guarantee, whether there had been an effective agreement to extend the works cover provided by the original policy to the undertaking of the repairs;
 - (g) whether Pirelli had any liability by the terms of its contract with Hydro-Quebec for the costs of repairing the cable as opposed to maintaining it; and
 - (h) quantum.
14. By 26th March 2001 Pirelli had refined its claim, which it proceeded to set out in a memorandum to Generali. It appears from this document that Pirelli rationalised its claim on the basis that there had been two losses. It identified the first as having occurred on 30th August 1998, described it as being unforeseen and sudden, sought to refute the suggestion that it was the result of wear and tear, and attributed it to a fault in erection. After application of a 20% deductible, it claimed Can\$1,463,218 under the Maintenance Guarantee coverage in respect of this first loss. Pirelli identified the breaking of the cable during the repair operations as the second loss and, after applying a deductible of 10%, claimed Can\$4,134,418 under the "Works" cover which it said had been "reinstated" for the repairs. After adjustments, Pirelli reduced its aggregate claim for the two losses to Can\$4,623,723.
 15. Generali had been in negotiation with Pirelli over several months. At a meeting on 3rd April 2001, Pirelli offered to accept Can\$4,000,000 in settlement of its claim under its insurance and threatened that, if its offer was rejected, it would launch legal proceedings in Canada and would seek an award of punitive damages in addition to its claim for an indemnity. On 24th April 2001, Generali accepted Pirelli's offer. Generali prepared an Acceptance Form for Pirelli which the latter signed and dated on 7th May 2001 and returned to Generali. There is no suggestion in any of the contemporaneous documents that the settlement or any payment pursuant to it was made under any reservation of rights or on the basis of no admission of liability or on the basis that there was no liability.
 16. On 27th April 2001, Generali wrote to the brokers to whom the open cover had been issued by the Defendants, setting out the basis on which Generali considered that it had been liable for the loss claimed by Pirelli. It appears to have treated the claim by Pirelli as justifiable on the basis that there had been one loss, not two; that it had been caused by faulty design (on the basis that Pirelli did not apply adequate safety design criteria to provide for stabilisation of the cable in case the bottom conditions were other than simply sandy) and/or fault in erection/bad workmanship (on the basis that Pirelli should have avoided the rock-shelf in question or stabilised the cable in that precise area); and that it fell within the cover provided by the Maintenance Guarantee.

THE ISSUES and THE TEST FOR SUMMARY JUDGMENT

17. The principal issues which arise on the present application are as follows:

- a. the proper construction of the follow the settlements provision in the Conditions set out in the contract of reinsurance between Generali and the Defendants: in particular which, if any, out of the three alternative constructions proposed by Generali and that proposed by the Defendants is correct?
 - b. whether the settlement was ex gratia;
 - c. if the Defendants are bound by the basis upon which Generali recognised Pirelli's claim, what that basis was;
 - d. whether the loss claimed by Pirelli fell outside the terms of the contract of insurance by reason of any of the matters pleaded in paragraph 16 of the Defence or proposed to be pleaded by amendment to that paragraph in the Defence: namely for example, because it was not unforeseen and was not sudden; because it was excluded by Special Exclusions 1c) and/or 1d) on the basis that it resulted from faulty design or bad workmanship not constituting faults in erection, or from wear and tear; because it did not constitute a fortuity covered by the policy; because it did not result from faults in erection or any of the other matters covered by the Maintenance Guarantee; because Pirelli had no liability to Quebec Hydro in respect of the loss;
 - e. whether the loss fell outside the terms of the reinsurance by reason of precisely the same matters as are pleaded or are proposed to be pleaded in paragraph 16 of the Defence, as set out in subparagraph d above;
 - f. whether Generali failed to take all proper and businesslike steps in settling the claim because it was arguably not recoverable under the contract of insurance by reason of any of the matters pleaded or proposed to be pleaded in paragraph 16 of the Defence, as set out in sub-paragraph d above;
 - g. whether Generali settled the claim directly with Pirelli under the original policy of insurance to which it was not a party and, if it did, whether for that reason the settlement does not fall within the follow settlements language of Declaration number 1 and/or is ex gratia;
 - h. whether endorsement number 5 to the contract of reinsurance between Generali and the Defendants applies and, if it does, whether the Defendants are entitled to limit any liability that they might have to Generali to their respective proportions of Can\$1 million; and
 - i. whether the principle of average should apply, and whether there was any separate insurance available to Hydro Quebec that would have responded to Pirelli's claims.
18. It became apparent early on in the course of the hearing that the issues which Generali's application raised, with the possible exception of the principal issue of construction, gave rise to seriously disputed issues of fact.
19. CPR Part 24.2 provides as follows:
- "The Court may give summary judgment against a claimant or defendant on the whole of a claim or on a particular issue if*
- (a) *it considers that*
 - (i) *that claimant has no real prospect of succeeding on the claim or issue; or*
 - (ii) *that defendant has no real prospect of successfully defending the claim or issue; and*
 - (b) *there is no other compelling reason why the case or issue should be disposed of at a trial."*
20. In the light of the guidance given by **Swain v Hillman** [2001] 1 All ER 91 (CA) and **Three Rivers DC v Bank of England** [2001] 2 All ER 513, an application under Part 24 should be approached as follows:
- i. Part 24 confers on the court an exceptional power since the ordinary principle, which is established to meet the ends of justice, is that disputes are to be resolved at trial on the evidence and after completion of disclosure.
 - ii. Part 24 is to be applied in the interests of all concerned to dispose of cases or issues that are not fit for trial at all.
 - iii. The test whether a case or issue is fit for determination on an application for summary judgment is whether there is a real prospect of the claim or defence, as the case may be, succeeding in circumstances where "real" is to be equated with "realistic" and contrasted with "fanciful".
 - iv. A Part 24 application is not to be used for the conduct of a mini-trial on the documents chosen to be deployed by the parties without disclosure or oral evidence. Where the case or issue is complex or its determination is time-consuming, the court must be astute not to allow an application for

summary judgment to turn into a mini-trial and should consider with care whether or not the application should be permitted to proceed. However, where there is a realistic prospect of benefit to the parties, the court may permit the application to proceed but it will be necessary for it to keep in mind the nature of the exercise that is permissible under Part 24.

21. Having regard to these considerations, it was recognised on behalf of Generali (as also it seemed to me) that it was not appropriate for Generali to proceed with its Part 24 application on those issues that gave rise to serious and complex disputes of fact. Therefore, Generali decided to confine its application for summary judgment to two issues: the issue of construction of the follow the settlements provision in the contract of reinsurance and the issue whether or not Generali's settlement was ex gratia. However, Generali invited the court to go further in relation to the issue of construction and to come to a final decision on it even if it might be said that both parties possessed arguments which could be described as having (at least at the outset) a real prospect of success. It seemed to me appropriate that the court should endeavour to come to a final decision on the issue of construction. Once an issue of construction is before the court whether on an application under Part 24 or otherwise, then unless it is realistic to suppose that admissible and relevant evidence on the issue will emerge at trial, or unless the issue cannot be segregated from other issues requiring resolution at trial, it will not infrequently be sensible and appropriate for the court to take the issue and determine it there and then. In this case, both Mr. Stephen Hofmeyr Q.C. who appeared on behalf of Generali and Miss Sioban Healy who appeared on behalf of the Defendants told me that there was and would be no further admissible and relevant evidence in relation to the issue of construction. I understand the Defendants to accept that it is appropriate that the court should finally decide the issue of construction at this stage of the proceedings, and I have concluded in the circumstances that I should do so.

CONSTRUCTION

22. For Generali, Mr. Hofmeyr Q.C. proposed three alternative constructions of the provision in the contract of reinsurance: "*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. Including deviation and/or change of voyage and/or extension of the original policy, as original.*"
23. Generali's primary construction was that the effect of the provision was that the Defendants are obliged to indemnify Generali in respect of any settlement entered into by Generali under the underlying policy and/or fronting arrangement other than an ex gratia or without prejudice settlement or a settlement made in bad faith. Mr. Hofmeyr submitted that this construction was not only supported by the authorities, in particular *The Insurance Company of Africa v Scor (U.K.) Reinsurance Company Limited* [1985] 1 Lloyd's Rep. 312, but also by a number of additional factors. He submitted that the words "without question" precluded the Defendants from challenging both whether the settled claim fell within the underlying policy or policies and within the contract of reinsurance and also whether Generali had taken all proper and businesslike steps in making the settlement. He suggested that this was supported by the inferred intention of the provision that there should be a complete synchronisation of the scope of cover as between the underlying policy or policies and the reinsurance, and that it was reinforced by the exception of ex gratia and without prejudice settlements which, he submitted, would not need exclusion if it was necessary for Generali to establish its liability under the underlying policy or policies. In any event, Mr. Hofmeyr submitted, it was inappropriate to imply any obligation that Generali should take all proper and businesslike steps in making the settlement in circumstances where, because of Generali's 20% retention, reinsurers are protected by the fact that the reassured is in a similar position to them.
24. Generali's secondary construction was that the provision binds the Defendants to all settlements made by Generali, other than ex gratia and without prejudice settlements, so long as the claim "*as recognised*" by Generali prima facie falls within the risks covered by the reinsurance as a matter of law and so long as the settlement was made other than in bad faith. The difference between the way in which Generali put its primary case on construction and this alternative formulation is that, under this

formulation, Generali has firstly to identify the basis on which it recognised the claim in order secondly to establish that the claim, as recognised by it, prima facie falls within the risks covered by the contract of reinsurance as a matter of law. Mr. Hofmeyr submits that this formulation is supported by the judgment of Robert Goff L.J. in *The Insurance Company of Africa v Scor (U.K.) Reinsurance Company Limited*, and that, under the second way in which he put his case, the words "without question" are to be confined to precluding the Defendants from questioning whether Generali had taken all proper and businesslike steps in making the settlement.

25. Generali's "tertiary construction", as Mr. Hofmeyr put it, was that the provision binds the Defendants to all settlements made by Generali so long as (a) the claim as recognised by Generali (i.e. the basis on which Generali recognised the claim) falls within the risks covered by the reinsurance as a matter of law and (b) in settling the claim, Generali acted honestly and took all proper and businesslike steps in making the settlement.
26. The Defendants' case was that, upon a proper construction of the follow the settlements provision in the contract of reinsurance, they are not liable to provide an indemnity unless the loss falls within the risks covered by the underlying policy or policies and also the contract of reinsurance as a matter of law and unless, in settling the claim, the underlying insurers acted in good faith and took all proper and businesslike steps in making the settlement. Miss Sioban Healy for the Defendants submitted that the express term excluding ex gratia settlements from the ambit of binding settlements meant that, while the Defendants were bound by the factual basis on which the settlement was reached because of the principles established in *The Insurance Company of Africa v Scor (U.K.) Reinsurance Company Limited*, Generali still had to prove on that factual basis that the loss gave rise to an actual liability under the terms of both the contract of insurance and also the contract of reinsurance; and that the words "without question" did no more than declare the position established in *The Insurance Company of Africa v Scor (U.K.) Reinsurance Company Limited*. In relation to the secondary way in which Generali put its case, Miss Healy added that, reading the judgment of Robert Goff L.J. in *The Insurance Company of Africa v Scor (U.K.) Reinsurance Company Limited* accurately, the first proviso to which Robert Goff L.J. referred looks to "the claim so recognised" by the insurers and not to "the claim as recognised" by the insurers. Therefore, Miss Healy argued, it was irrelevant how the insurers happened subjectively to regard a claim when they came to dispose of it. It was, I think, implicit in Miss Healy's argument that an objective test has to be applied in order to ascertain the real basis on which a claim has been settled regardless of how the claim might have been formulated by the assured or viewed by the insurer, and regardless of how the settlement might have been structured or worded. Miss Healy's overarching submission was that, on any view, the settlement reached by Generali was not binding on the Defendants unless the claim so settled fell within the risks reinsured as a matter of law and, therefore she submitted, Generali still had to prove that, on the factual basis established by the settlement, the underlying loss was covered by the terms and conditions of the contract of reinsurance notwithstanding that Generali and the underlying insurers might reasonably and properly have settled any and all arguments of liability arising in connection with the identical terms and conditions under the original contract of insurance.
27. Both parties put in the forefront of their respective cases the statement by Lord Mustill in *Hill v Mercantile and General Reinsurance Co. PLC* [1996] 1 W.L.R. 1239, 1251: "There are only two rules, 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."
28. It seems to me that the loss referred to by Lord Mustill in his expression of the first rule is the original loss that P.O. Lawrence J. spoke about in his formulation of the statement of principle in *Re London County Commercial Reinsurance Office Limited* [1922] 2 Ch. 67, 80: "It is well settled that (subject to any provision to the contrary in the reinsurance policy) the reassured, in order to recover from their underwriters, must prove the loss in the same manner as the original insured must have proved it against them, and the reinsurers can raise all defences which were open to the reassured against the original assured."

29. Lord Mustill's expression of the second rule was a reflection of the fact, referred to parenthetically by P.O Lawrence J. in the quote above and identified in situations covered by authority or considered in dicta, that insurers and reinsurers have on occasion agreed to introduce into their contracts of reinsurance special clauses: in pursuit of the insurers' (the reassured's) endeavour, in Hobhouse L.J.'s words in *Toomey v Eagle Star Insurance Co. Ltd.* [1994] 1 Lloyd's Rep. 516, 523, "to get round the need to prove their loss by proving an insured loss of the original subject-matter."
30. Thus it was that different forms of clauses were developed and included in contracts of reinsurance. Since the "follow the settlements" clause in this case appears to have borrowed the formulaic language used in different versions of earlier clauses relied upon by insurers in their endeavour to avoid having to prove an insured loss of the original subject-matter, it may be significant to identify those situations that have been covered by authority or considered in dicta.
31. The first relevant clause that was considered in the authorities contained the phrase binding reinsurers "to pay as may be paid thereon" - "thereon" being a reference to the original contract of insurance. The parties in this case have introduced a similar phrase into their own follow the settlements clause. The history and meaning of the phrase were analysed in detail by the Court of Appeal in *The Insurance Company of Africa v Scor (U.K.) Reinsurance Company Limited* [1985] 1 Lloyd's Rep. 312. The conclusion of the several authorities, as analysed in the Court of Appeal, was that the effect of those words was to bind reinsurers to a compromise by the insurers of the question of the amount of a claim: so that, provided that the insurers could establish a loss of the kind insured and reinsured, and that the reinsured had acted honestly and had taken all proper and businesslike steps to have the amount of the loss fairly and carefully ascertained, reinsurers were obliged to indemnify the insurers in respect of that amount. Insurers were thus relieved of the obligation of proving the true quantum of the loss in the same way as the original assured was required to prove it against them: *Western Assurance Co. of Toronto v Poole* [1903] 1 K.B. 376.
32. The parties in this case have not confined themselves in the contract of reinsurance to the deployment of the phrase "to pay as may be paid thereon". They have adopted in this case a form of clause that includes also a phrase by which the reinsurers promised to follow the settlements of the reassured. The leading case on the meaning of the words "follow the settlements" is the decision of the Court of Appeal in *The Insurance Company of Africa v Scor (U.K.) Reinsurance Company Limited* [1985] 1 Lloyd's Rep. 312. The judgment of Robert Goff L.J. is recognised as having set out the authoritative propositions of law. Robert Goff L.J. approved the approach of Branson J. in *Excess Insurance Co. Ltd. v Mathews* (1925) 23 Ll.L.Rep. 71 (a case where insurers and reinsurers had also combined the words "to pay as may be paid thereon" with the words "and to follow their settlements). Branson J. was of the view that the effect of the words "follow their settlements" bound reinsurers to a compromise by the insurers on a question of liability in the same way as they were bound under the words "pay as may be paid thereon" on a question of amount.
33. Robert Goff L.J. identified two important provisos qualifying this proposition. The first proviso was, it seems to me, in recognition of the fundamental principle that contracts of insurance and of reinsurance are independent bargains and of the fact that, purely by agreeing to follow the insurers' settlements under the former, reinsurers did not confer on the insurers the unilateral right to determine the meaning and scope of the latter. It was to the effect that the obligation imposed by the follow the settlements wording on reinsurers to indemnify insurers in respect of their settlements of claims under the contract of insurance was subject to the condition that the claims recognised by the insurers fell within the risks covered by the contract of reinsurance as a matter of law. The second proviso was, it seems to me, in recognition of the fact that, under a follow the settlements wording, insurers have exclusive control of the whole handling and making of a settlement that could significantly affect reinsurers' interests under the reinsurance contract to insurers' advantage. It was consistent with the approach that Bigham J. had adopted in relation to the words "to pay as may be paid thereon" in *Western Assurance Co. of Toronto v Poole* and was to the effect that the obligation to follow the settlements of insurers was itself subject to the implied obligation that the insurers should

have acted honestly and also should have taken all proper and businesslike steps in making the settlement.

34. Robert Goff L.J. said, page 330: *"The intention must, in my judgment, have been to bind [re]insurers to follow settlements even where the effect was that they could not dispute that there was in fact liability on the insurers under their policy with the assured.*

*In my judgment, the effect of a clause binding reinsurers to follow settlements of the insurers, is that the reinsurers 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 that the claim so recognised by them falls within the risks covered by the policy of reinsurance as a matter of law, and provided also that in settling the claim the insurers have acted honestly and have taken all proper and businesslike steps in making the settlement. This construction seems to me to be consistent with the approach of Mr. Justice Branson in *Excess Insurance Co. v Mathews*. In particular, I do not read the clause as inhibiting reinsurers from contesting that the claim settled by insurers does not, as a matter of law, fall within the risks covered by the reinsurance policy; but in agreement with Mr. Justice Bigham, I do consider that the clause presupposes that reinsurers are entitled to rely not merely on the honesty, but also on the professionalism of insurers, and so is susceptible of an implication that the insurers must have acted both honestly and in a proper and businesslike manner... Furthermore, in my judgment, if insurers have so settled a claim, acting honestly and in a proper and businesslike manner, then the fact that reinsurers may thereafter be able to prove that the claim of the assured was fraudulent does not of itself entitle reinsurers not to follow the settlement of the insurers. In my judgment, they must follow the settlement, as they have contracted to do;"*

35. Thus, subject to the application of the two provisos, the effect of the follow the settlements wording is that the reinsurers are obliged to indemnify the insurers in respect of their compromise of the original assured's claim on both any question of liability and also any question of amount. The follow the settlements wording thus represents one possible way by which the parties may agree on how insurers can satisfy the requirement (recognised by Lord Mustill as the first part of the first obvious rule in *Hill v Mercantile and General Reinsurance Co. PLC*) that they should prove the loss in the same manner as the original insured must have proved it against them, i.e. that the loss falls within the cover of the policy reinsured.
36. The settlements referred to in the follow the settlements wording are those between the insurers and their assureds. Therefore, the words do not, in themselves, relieve the insurers of their obligation (recognised in suitably modified form in Robert Goff L.J.'s first proviso) to prove that the loss, in the words of Lord Mustill in *Hill v Mercantile and General Reinsurance Co. PLC*, also falls within the cover created by the reinsurance (the second part of what Lord Mustill identified as the first obvious rule). However, those words "*follow the settlements*" do have an impact on how insurers may satisfy that requirement. The reason why they have an impact is because the parties have already, by the follow the settlements wording, agreed that the insurers should be relieved of the obligation to prove that the loss falls within the cover of the policy reinsured. In its stead, they have agreed that it is sufficient for the insurers to show that they have settled a claim under the original policy and that they have acted honestly and have taken all proper and businesslike steps in doing so. It follows that what insurers, who have thus settled a claim under their contract of insurance, have to prove in order to secure an indemnity under their contract of reinsurance is not that the original loss falls within the cover created 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.
37. It is perhaps instructive in this context to examine and compare what Bigham J. said in the absence of a follow the settlements clause in *Western Assurance Co. of Toronto v Poole* with what Robert Goff L.J. said about the meaning and effect of such a clause in *The Insurance Company of Africa v Scor (U.K.) Reinsurance Company Limited*. Bigham J. made it clear that, subject to the pay as may be paid thereon wording, in order the prove their entitlement to an indemnity from reinsurers, the insurers were required to show both that liability existed under the insurance and also that a loss of the kind reinsured had in fact happened. By contrast, Robert Goff L.J. did not speak of insurers having to prove a loss or a liability under the original cover, or that a loss of the kind reinsured had in fact happened.

Robert Goff L.J. stated that what insurers had to prove (apart from any issue arising in relation to whether they had acted honestly and had taken all proper and businesslike steps) was that the claim that they had disposed of by admission or compromise and thus had recognised, fell within the risks covered by the policy of reinsurance as a matter of law.

38. The distinction between having to prove that an original loss falls within the cover provided by a contract of insurance and also by a contract of reinsurance, and having to prove that a claim that has been recognised by the insurers as falling within the cover provided by a contract of insurance also falls within the cover provided by a contract of reinsurance, is significant. In the former, one is examining what in fact happened and whether, on the basis of what actually happened, the insurers are liable to indemnify the assured under the contract of insurance and the reinsurers are liable to indemnify the insurers under the contract of reinsurance, according to their respective terms. In the latter, one is examining the claim recognised by the insurers by their settlement of it by admission or compromise and whether on that basis the claim falls within the reinsurance cover as a matter of law.
39. When one is examining the claim recognised by the insurers when they settle it by admission or compromise, one is examining the real basis on which the claim has been settled. That may not equate with what the assured might have claimed to have happened and to fall within the contract of insurance, nor with what the insurers might advertise as the basis of the settlement, although these might be important starting points and considerations in ascertaining the real basis. If it were otherwise, the rights and obligations of the insurers and reinsurers might be dependent on how an assured decided to formulate its claim possibly in deliberate disregard of the real ascertainable and even ascertained facts and the law, or on how an insurer decided how to frame the terms of settlement in equivalent disregard of those same facts and principles of law. I do not think that this can be right.
40. In examining the real basis on which a claim has been settled, one is looking to identify the factual and legal ingredients of the claim embodied and thus recognised in the settlement. Each case will, of course, depend on its individual circumstances. It is unlikely that all those ingredients will be explicit on the face of the settlement. The settlement and the circumstances in which it came to be made, including communications between assured and insurers and investigations internal to the insurers, may well have to be examined. Thus, the identification of the loss, the circumstances in which it came to occur, the causes of it, whether and how particular terms of the contract of insurance which could impact upon its recoverability were considered, might all be matters relevant to the identification of the real basis on which the claim was settled; and thus to ascertaining whether the claim recognised by the insurers, when by admission or compromise they came to settle it, falls within the reinsurance as a matter of law.
41. Since a contract of insurance and a contract of reinsurance are two separate independent bargains (see, for example, per Buckley L.J. in *British Dominions General Insurance Co. Limited v Duder* [1915] 2 K.B. 394, 400), unless the contract of reinsurance provides otherwise, it should always be the case that the reinsurers who have agreed to follow the settlements of their insurers are nevertheless entitled to require the insurers to prove that the claim that they have recognised by their settlement of it falls within the risks covered by the contract of reinsurance as a matter of law. The question that arises is whether and, if so, to what extent, the insurers and reinsurers have agreed as between themselves to modify this principle by requiring the latter to follow the former's settlements of inward claims under the insurance upon terms and conditions that they have decided should also regulate the insurers' rights of indemnification under the reinsurance.
42. In principle, the facts that a contract of insurance and a contract of reinsurance may be back to back and subject to identical terms and conditions, and that the reinsurers have agreed to follow the settlements of their insurers, do not mean that what may be described as a proper and businesslike settlement by the insurers of a claim made against them by their assured under the insurance dictates that the insurers are entitled to an indemnity from their reinsurers. The claim made by the assured and recognised by the insurers by their settlement of it under the insurance may have been settled on a basis which, even if valid, did not fall within the risks insured against as a matter of law. In this instance, it would necessarily follow that the claim recognised by the insurers by their settlement of it

was one which, by definition, fell outside the risks covered by the contract of reinsurance as a matter of law.

43. Examples of this instance may explain the conclusion. One may envisage back to back contracts of insurance and reinsurance containing identical exclusion clauses or warranties relating to the subject-matter of the insurance where the contract of reinsurance also contains a follow the settlements clause. The assured may make a claim which, because of the existence of warranties or exclusion clauses in the contract of insurance (replicated by incorporation into the contract of reinsurance), fell outside the scope of the insurance contract. However, the assured's claim is advanced and maintained on the basis that the insurers have waived reliance on those clauses and thereupon, acting honestly and after taking all proper and businesslike steps, the insurers settle. The basis on which the claim was settled in this example would not be a liability (admitted or compromised) upon the terms and conditions of the contract of insurance: it would be because the insurers had deprived themselves of the ability to rely on those terms and conditions in order to show that the risk fell outside the scope of the insurance as a matter of law. The existence of a follow the settlements clause in the contract of reinsurance would not, in those circumstances, of itself entitle the insurers to recover an indemnity from their reinsurers: the insurers would be still required, but would be unable, to show that the settled claim fell within the risks reinsured. Put another way, the insurers' settlement of the claim in this example and the presence of a follow the settlements clause in the contract of reinsurance should not disentitle the reinsurers from relying upon the warranties and exclusion clauses in their own contract of reinsurance in order validly to demonstrate that the claim so recognised by the insurers did not fall within the risks covered by the contract of reinsurance as a matter of law.
44. Another example may further illustrate the point. If a contract of insurance contains an exclusion, amongst others, in respect of all losses characterised as fair wear and tear and, overlooking the exclusion, the insurers settle a claim for loss on the basis that it is fair wear and tear, that basis, assuming it to be valid, would fall outside the risks covered by a back to back contract of reinsurance as a matter of law. Suppose, however, that the insurers considered the application of the exclusion clause and determined both on the facts and on the law that it did not apply or arguably did not apply to exclude the loss and they accordingly settle on the basis of an admission or compromise of liability under the terms and conditions of the insurance. The real basis on which the claim will have been recognised in these circumstances will have been that the loss did not comprise excluded fair wear and tear. Therefore, the claim so recognised (i.e. the real basis, assuming it to be valid, on which the claim was settled and thus recognised) would fall within the risks covered by the contract of reinsurance as a matter of law and, save possibly for the purposes of challenging the insurers on the basis of the second *Scor* proviso, the reinsurers would not be entitled to reopen the issue. Finally, since the task upon which I am engaged has become somewhat academic, I should not ignore a further possible case where the insurers settle a claim on the basis of facts that demonstrate that the loss claimed by the assured is fair wear and tear in circumstances where the insurers overlook the legal implications of those facts and ignore the exclusion clause. In this last case, it seems to me (irrespective of the possible relevance of the second *Scor* proviso) that, according to the basis on which it was settled and in the absence of any recognition by admission or compromise that the exclusion in respect of fair wear and tear did not or arguably did not apply, the claim so recognised falls outside the contract of reinsurance as a matter of law.
45. A last example may be found in the case of the Wellington Agreement, which was the subject-matter of an appeal from an arbitration award to the High Court (Evans J.) in *Hiscox v Outhwaite (no. 3)* [1991] 2 Lloyd's Rep. 524. The reinsured syndicate provided liability cover to a number of assureds engaged in the asbestos industry. Because the number of actual and potential claimants was so great and because the amount of the actual and potential damages was so enormous, several asbestos producers and their insurers entered into what was known as the Wellington Agreement. Thereafter, all claims involving the parties to the Agreement were handled through the facility that had been set up in accordance with its terms, and the amounts paid in settlement of those claims were shared rateably among all subscribing producers irrespective of individual responsibility for the underlying claims. This had the result that some of the payments, or some parts of the payments, made by the

syndicate were in respect of claims by asbestos sufferers for which its insured producers were not and could never have been responsible. In those cases, the syndicate was liable under the Agreement to pay its due proportion of claims made against other asbestos producers which it did not insure but for which its own insured producer became liable pro rata under the terms of the Agreement. As the arbitrator concluded, payments were made by the syndicate without any basis of legal liability to the recipients other than the rules of the complex arrangement embodied in the Wellington Agreement. The syndicate sought an indemnity in respect of those payments from its reinsurers under its contract of reinsurance, relying on wording that was accepted as being the equivalent of a follow the settlements clause and upon the fact that the contract of reinsurance incorporated all the terms and conditions of the underlying contracts of insurance between the syndicate and its asbestos producer assureds. It was argued on behalf of the syndicate that the effect of the contract of reinsurance was that the reinsurer was precluded from raising any issue as to the scope of the risks covered by the contract of reinsurance in circumstances where a claim was asserted under the contract of insurance which the insurer properly compromised within the meaning of Robert Goff L.J.'s second proviso in *The Insurance Company of Africa v Scor (U.K.) Reinsurance Company Limited*. Evans J. rejected this argument. Whilst he was prepared to accept that a reasonable compromise could cover both disputed questions of law as well as disputed questions of fact, he had difficulty in seeing how that could lead to the conclusion, for which the insurers were contending, that the reinsurers should therefore be liable in respect of any payment that the syndicate might prudently and honestly make in respect of claims against it by its assured. He held that: *"The disputed payments were in respect of non-insured claims, which by definition were not within the scope of the reinsurance contract. They did not become insured, and therefore reinsured, claims merely because the syndicate agreed to treat them as if they were."*

46. This passage has to be read in its context: namely, in relation to claims made under the contract of insurance that were in respect of losses or liabilities that avowedly did not fall within the risks covered by that contract as a matter of law. There had never been any issue between the syndicate and its assureds, or any compromise between them of any question of liability or fact, with regard to whether the claims that the syndicate paid fell within the scope of the risks covered by the contract of insurance. Thus it was specifically not the basis on which the claims were settled that they were covered by the contract of insurance as a matter of law. By contrast, it is apparent from earlier passages in the judgment leading up to the extract quoted above that Evans J. was of the view that, under contracts of reinsurance that both follow the terms of the underlying contract and also follow settlements, the insurers may be able to recover an indemnity from their reinsurers in respect of settlements of claims which arguably as a matter of law fell within the scope of the original contract regardless of whether a court might in fact hold, after full argument, that they did not.

47. Evans J. said, pages 530 -1: *"The principle stated in Scor's case is unexceptional, but its application gives rise to difficulty where the terms of the reinsurance contract are the same as those of the underlying insurance contract, and the reinsurer has agreed to follow the settlements of the original insurer/reinsured. This difficulty was recognised by the Court of Appeal in Hong Kong in Insurance Co. of the State of Pennsylvania v Grand Union Insurance Co. [1990] 1 Lloyd's Rep. 208. In the leading judgment, Hunter J.A. said this:*

Two points, I think, have to be noticed about these two 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 Lord Justice Goff meant that, he would in Mr. Justice Mortimer's words "be nullifying the conclusion that he had 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."

....

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 where 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 businesslike 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.

My difficulty, to which I referred earlier, is that the present is not such a case. .. The arbitrator distinguished between two kinds of payments made by the Syndicate under the Wellington Agreement: those which are in respect of claims for which the insured producer would have been liable in any event, and others for which no such liability would have existed without the agreement, the claims being asserted against non-insured producers only. The disputed payments were in respect of non-insured claims, which by definition were not within the scope of the reinsurance contract."

48. There was some debate before me as to the identification of the proviso to which Evans J. was referring and which he stated that he had assumed in the syndicate's favour. It seems clear to me that what Evans J. was referring to was his statement at page 529 of the report that he *"was prepared to hold, in favour of the Syndicate, that a reasonable 'compromise' within [the follow the settlements wording] may well cover disputed issues of law as well as of fact."* As for the difficulty to which he was referring in the last paragraph quoted above, it was the difficulty *"in understanding why [the fact that a reasonable 'compromise' may well cover disputed issues of law as well as of fact] leads to the conclusion .. that reinsurers are therefore liable in respect of any payment which the Syndicate chooses to make in respect of claims by its insureds."*
49. It is apparent that Evans J. was of the view that, in a case where the risks reinsured are co-extensive with those originally insured, the effect of the reinsurers' agreement to follow the settlements of the insurers may be to bind the reinsurers by a compromise of a dispute between the insurers and their assureds as to liability, including as to whether the claim is covered by the risks insured under the contract of insurance as a matter of law, provided that the insurers have acted honestly and have taken all proper and businesslike steps in making the settlement: with the consequence that the reinsurers cannot reopen the precise same question for the purposes of disputing liability under the terms of the contract of reinsurance or contesting that the claim does not fall within the risks covered by the contract of reinsurance as a matter of law.
50. Evans J. was clearly drawing a distinction between those settlements by the insurers of claims about which there had been no dispute, or about which there could not have been any realistic dispute, that the losses in question did not fall within the risks covered by the contract of insurance as a matter of law (in respect of which the insurers could not be held legally liable to pay), and those settlements by the insurers of claims about which there had been a genuine dispute as to whether, or it was presumably seriously debatable that, the losses in question did fall within the risks covered by the contract of insurance as a matter of law. He concluded in relation to the former that, however honest and reasonable the settlements may have been in the circumstances that prevailed (for example, it was argued that the Wellington Agreement was overall commercially and practically beneficial to assureds, insurers and reinsurers alike), the reinsurers were not precluded from raising issues as to the scope of the reinsurance contract and were not obliged by follow the settlements language to indemnify the insurers in respect of their settlements of such claims. He concluded in relation to the latter that the reinsurers "may well be bound" to follow the insurers' settlements and, implicitly therefore, may well be precluded from raising under the contract of reinsurance the same issues in relation to liability and scope of cover as had already been disputed and compromised, or admitted, by settlement under the contract of insurance.
51. Evans J. did not explain the reasons for his view since it was unnecessary on the facts of the case with which he was concerned for him to do so. It seems to me, however, that there are at least three reasons which support the distinction which Evans J. made and the provisional conclusion to which he appears to have come. First, if the reinsurers were to have the ability to reopen the same issues of

coverage as a matter of law under the contract of reinsurance as those which the insurers had admitted or compromised under the contract of insurance in circumstances where the parties had deliberately ensured that the reinsurance should be back to back with the insurance, the result would in practical and legal terms be similar to that which would obtain if the parties had agreed that the promise by the reinsurers to follow the settlements of the insurers should be subject to the settlements coming within the terms and conditions of both the contract of insurance and the contract of reinsurance. That, however, was not agreed either expressly or impliedly. Secondly, reinsurers having entrusted the insurers with their confidence in determining and compromising any disputes in relation to whether any claims made under the contract of insurance fell within the risks covered by the contract of insurance as a matter of law in circumstances where the risks covered by the contract of reinsurance were identical, it would be inconsistent for the reinsurers to be able thereafter to dispute the self same questions of law arising in connection with the identical terms and the equivalent scope of cover under the contract of reinsurance. It is implicit in the combination of the fact that the contracts were deliberately back to back with the promise by the reinsurers to follow the settlements of the insurers that, if the insurers upon the taking of all proper and businesslike steps honestly compromise a dispute concerning the scope and application of the contract of insurance, the reinsurers should be bound to follow the insurers in respect of that settlement. Thirdly, and following from the above, the follow the settlements promise binds the reinsurers to a proper and businesslike compromise by the insurers of the question of liability or a proper and businesslike admission of liability under the contract of insurance whether the insurers were legally liable to the assured or not. For the insurers then to have to prove to the reinsurers that, on the settled facts, they were legally liable to the assured, which would be the inevitable consequence (if indirect) if the reinsurers were entitled to require the insurers to establish that on the settled facts the claim fell within the risks reinsured, would replace the unqualified follow the settlements promise with something significantly different.

52. It was submitted on behalf of the Defendants that this conclusion cannot stand in the light of the speech of Lord Mustill in *Hill v Mercantile and General Reinsurance Co. PLC*. I do not agree. In that case, Lord Mustill had to consider a different and significantly qualified form of follow the settlements clause in reinsurances which, unlike the policies in *Hiscox v Outhwaite (no. 3)* and in this case, were not subject to the identical terms and conditions to be found in the original insurance policies. The crucial words in the special form of follow the settlements clause with which Lord Mustill was concerned were those contained in the two provisos that qualified the effect of any settlements made by the reassureds: they were to be binding on the reinsurers only "*providing that such settlements are within the terms and conditions of the original policies and/or contracts and within the terms and conditions of this reinsurance*". The effect of those words was, Lord Mustill concluded, to prevent "*even an honest and conscientious appraisal of the legal implications of the facts embodied in an agreement between parties down the chain to impose on the reinsurers risks beyond those which they have undertaken and those which the reinsured have undertaken.*" Because it was unnecessary for him to do so, Lord Mustill did not engage in an analysis of the authorities which have considered unqualified follow the settlements clauses, and he did not seek to express a view on their proper construction in circumstances where they were to be found in contracts of reinsurance that were consciously made back to back with underlying contracts of insurance. He did however implicitly acknowledge that circumstances could arise in which, on different wording from that with which he was concerned, reinsurers may well be agreeable to be bound by the honest and conscientious appraisal of the legal implications of facts embodied in an agreement down the chain between parties down the chain from themselves. Thus, in considering the situation where the insurance and the reinsurance are on the same terms and where the parties are essentially co-adventurers (he gave the examples of participatory insurance, or facultative reinsurance with a large retention), he concluded that the interests of insurers and reinsurers were broadly the same, and that it would "not be imprudent for the reinsurers to put themselves unconditionally in the hands of their reinsured for the settlement of claims which will be passed on to them." He contrasted that situation with that of "a remote reinsurer who may know nothing beyond the identity of his reinsured, and the terms of his own cover [who therefore] could hesitate to entrust his liabilities to a

stranger, which is what will happen if all the reinsurances down the chain embody unqualified follow settlements clauses."

53. Whilst these last quoted passages in Lord Mustill's speech should not be taken out of context, they tend if anything to fortify rather than undermine the conclusion that, where reinsurers have bound themselves to a contract of reinsurance (in particular a facultative or proportional contract of reinsurance, not for example excess of loss) containing an unqualified follow the settlements clause in circumstances where the contracts of insurance and reinsurance are consciously back to back, the reinsurers have agreed that, if by admission or compromise the insurers accept liability under the contract of insurance on a basis which, if valid, falls within the risks covered by the contract of reinsurance as a matter of law, they will follow that settlement. *A fortiori*, if by admission or compromise of liability the insurers settle an issue concerning the scope and application of the contract of insurance, the reinsurers should not be entitled to raise the same issue on the same terms albeit this time under the contract of reinsurance. Subject as above, the reinsurers have to that extent consciously entrusted their liabilities to the insurers.
54. Turning to the follow the settlements clause in this case, it seems to me that this conclusion is reinforced, and any uncertainty is removed, by the specific wording of the provision in the reinsurance contract between the parties to these proceedings. 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 (re)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 businesslike 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 businesslike 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.
55. I am conscious that this conclusion may be interpreted as meaning that insurers in Generali's position have been empowered to decide not only upon the scope and meaning of their inward contract of insurance but also upon the scope and meaning of their outward contract of reinsurance; and that reinsurers in the position of the Defendants have thereby commensurately conferred upon the insurers the power to bind them to risks and liabilities beyond those expressed in their policies. It is, of course, not unknown in the insurance and reinsurance markets for insurers to be given such powers by their reinsurers: see, for example, the contract of reinsurance considered by the Court of Appeal in *Brown (RE) and others v GIO Insurance Limited* [1998] 1 LRLR 201. However, it seems to me more accurate in this case to say that the reinsurers have entrusted the insurers with their confidence in

ascertaining not only the facts of the claimed loss but also the legal implications of those facts under the terms and conditions of the original contract of insurance. If they had wanted to achieve otherwise, the contract of reinsurance could have had a follow the settlements clause in the same form as that construed by the House of Lords in the previous year in *Hill v Mercantile and General Reinsurance Co. PLC* [1996] 1 W.L.R. 1239. But it did not.

56. The conclusion which in my understanding Evans J. reached, and which I have respectfully endorsed, does not leave the reinsurers unreasonably exposed, or vulnerable to capricious or unreasonable behaviour on the part of the insurers. The second proviso set out by Robert Goff L.J. in *Scor*, namely that in settling any claim the insurers are required to act honestly and to take all proper and businesslike steps, should be entirely adequate to protect the reinsurers against that possibility: see *Charman v Guardian Royal Exchange Assurance PLC* [1992] 2 Lloyd's Rep. 607.
57. The analysis is made slightly more complex in this case by reason of the fact that Generali was not the insurer of the original assured: CIC was interposed between Generali and Pirelli, and reinsured 100% of the original risk to Generali. However, on the facts of this case, that makes no difference. The settlements that the Defendants bound themselves to follow were those by Generali of inward claims against Generali under the terms of its inward contract. That inward contract deliberately covered the same risks as were the subject of the original contract of insurance on identical terms and conditions. The risks covered by the contract between Generali and the Defendants were also deliberately coextensive with those of the original contract and were likewise subject to the identical terms and conditions. While there was no indication in the contract of reinsurance between Generali and the Defendants that Generali was not the direct insurer of the original assured (on the contrary, it seems to me to have been implicit in the structure and wording of the contract of reinsurance between Generali and the Defendants that the relationship between them would be back to back with one between Generali and the original assured, and that the terms and conditions governing the latter would be imported into the former in order to ensure total consistency and synchronisation between the two), in the final analysis that should make no difference in this case. The interposition of CIC necessarily meant that, legally, the relationship between Generali and the original assured was more remote than perhaps the contract between Generali and the Defendants suggested but in practical terms that was not so. The evidence is that the original contract of insurance was negotiated by Generali without any or any significant involvement by CIC, that CIC was merely interposed between the original assured and Generali in return for a fronting fee since Generali had an arrangement with CIC that the latter would front the former's Canadian risks, and that the involvement throughout of CIC was purely nominal.
58. In so far as it might be argued that the Defendants were unaware of the fronting arrangement between Generali and CIC and that they never intended or envisaged that they would be entrusting their liabilities to CIC (which according to Lord Mustill in *Hill v Mercantile and General Reinsurance Co. PLC* [1996] 1 W.L.R. 1239, 1252 "is what will happen if all the reinsurances down the chain embody unqualified follow settlements clauses"), the answer is that they did not in fact do so. The evidence is that, where Generali interposed CIC as a fronting company between itself and an original assured, it was normal for Generali to handle the investigation and adjustment of claims. That is what in fact happened in this case. Thus if, as appears to have been implicit in the contract of reinsurance between Generali and the Defendants, the Defendants were relying on Generali to have the responsibility for the making of settlements with the original assured of the original assured's claims and to undertake the onerous obligation to take all proper and businesslike steps in making any such settlements embodying admissions or compromises of liability, that reliance was not misplaced. Therefore, although Generali was not the direct insurer of the original assured, in every practical sense on the facts of this case it behaved as though it were, and on the basis that everything that it did was as much done on behalf of CIC as on its own behalf so that everything to which it bound CIC would be equally binding on itself. Thus, I conclude, Generali made a settlement under its inward contract with CIC which, subject to the application of the two *Scor* provisos as explained further by Evans J. in *Hiscox v Outhwaite (no. 3)* and above, the Defendants are bound to follow.

59. Turning to the particular ways in which the parties advanced their cases in argument, it will be clear from my analysis of the authorities and the applicable legal principles that I cannot accept Mr Hofmeyr's proposed primary or secondary constructions. The former resembled, if it did not in fact go further than, the rejected argument of the reassureds in *Hiscox v Outhwaite (no. 3)*. It would have the effect not only (a) of depriving the reinsurers of their right to require the insurers to establish that the claim recognised by them by their settlement of it fell within the risks reinsured as a matter of law in the sense in which the first *Scor* proviso was explained and applied by Evans J. but also (b) of relieving the insurers of their important obligation to take all proper and businesslike steps in their making of the settlement. I do not consider for the reasons that I have already expressed either that the authorities or legal logic can justify such an approach, or that the words "without question", on which Generali placed so much reliance can be given such far-reaching effect. The secondary way in which Mr. Hofmeyr put his case on construction confines the effect of the words "without question" to precluding the Defendants from challenging whether, in settling the original assured's claim (and thus CIC's claim under its reinsurance contract), Generali took all proper and businesslike steps. For the reasons that I have already expressed, I reject this approach. Moreover, I am not confident that Mr. Hofmeyr's formulation based, it is argued, on *Scor* that the effect of Robert Goff L.J.'s first proviso is that Generali must show that the claim as recognised by it prima facie falls within the risks covered by the reinsurance, accurately reflects the legal principle which that case established and which Evans J. explained and amplified in his judgment in *Hiscox v Outhwaite (no. 3)*. It seems to me that the correct analysis is that Generali must prove that the claim was disposed of by admission or compromise 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 in the manner explained above this judgment.
60. I reject Miss Healy's submission, which is a reflection of the Defendants' pleaded case, that, in order to recover, Generali has to prove that the loss falls within the risks covered by the underlying policy or policies and also the policy of reinsurance as a matter of law. The proposition that the insurers (the reassured) have to prove actual liability in respect of the loss under the terms of the original contract of insurance is inconsistent with the decision in *Scor*. The proposition that that the insurers have to prove that the original loss, as opposed to "the claim so recognised by them", falls within the risks covered by the contract of reinsurance is likewise inconsistent with the decision in *Scor*. I do not consider that the exception in relation to ex gratia and without prejudice settlements which is found at the end of the follow the settlements provision in the Defendants' contract with Generali assists Miss Healy in her argument. On the contrary, as it seems to me for the reasons that I have already expressed, the exception reinforces the conclusion that, if the basis of the insurers' settlement is an admission or compromise of liability on a basis that, if and assuming it to be valid, falls within the risks covered by the contract of reinsurance as a matter of law, the reinsurers cannot go behind the settlement but are bound by it even were they able to prove after trial that there was in fact no liability.
61. In conclusion, it seems to me that Mr. Hofmeyr's third and last construction, subject to qualification in accordance with the judgment of Evans J. in *Hiscox v Outhwaite (no. 3)* and to an understanding of what the first *Scor* proviso means when it refers to "*the claim so recognised*" is correct. 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 in this context as explained above, 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.

EX GRATIA

62. Mr. Hofmeyr invited me to decide on this application that the settlement made by Generali was not ex gratia. It seems to me that whether or not the settlement was ex gratia will depend on the ascertainment of the real basis upon which the claim by Pirelli was recognised by Generali's settlement of it. The resolution of what that basis was will turn on the facts. I do not consider that I can or should conduct a mini-trial on the basis of such facts as have been vouchsafed by Generali in its

evidence on this application. It seems to me that the issue of whether the settlement was ex gratia should be the subject of proper disclosure and ultimately, if necessary, oral evidence at trial. Therefore, I resist Mr. Hofmeyr's invitation.

63. Having said that, I am of the view that I can and should dispose on this application of the two positive arguments that Miss Healy has advanced in support of her case that Generali's settlement was ex gratia. Firstly, Miss Healy submitted that the settlement would be an ex gratia settlement and therefore not binding on the Defendants if the reassured was not in fact under any liability to the original assured. I reject this submission. I consider that the exception of ex gratia settlements covers settlements where the basis on which they were made was that there was no liability to indemnify. (Without prejudice settlements cover those where the basis on which they were made was that there was no admission of the existence of any liability under the terms and conditions of the original policy to indemnify.) If, however, the real basis on which the claim was settled and so recognised was an arguable liability to indemnify which, by the settlement, was admitted or compromised, the settlement would not be ex gratia and the question whether or not there was in fact a liability to indemnify, something that might be established after trial, is irrelevant. Secondly, Miss Healy submitted that Generali's settlement was ex gratia because, as she put it, the settlement was agreed and paid directly between Generali and Pirelli notwithstanding that the original contract was between CIC and Pirelli. I reject this submission also. The fact that Generali negotiated and agreed the settlement directly with Pirelli and paid the settlement amount directly to Pirelli is, it seems to me, irrelevant to the question whether the basis of Generali's settlement with CIC was that Generali had no liability to indemnify CIC under the contract of reinsurance between them. In so far as it matters, it seems to me to be clear that, by settling direct with Pirelli, Generali not only settled Pirelli's claim under the original contract of insurance but also settled a claim by CIC under Generali's inward contract of reinsurance on the same basis. The issue of what that basis might have been is, as I have indicated above, not something of which I consider that I can or should dispose on this Part 24 application.
64. I have mentioned in the course of this judgment that the Defendants wish to make certain amendments to their Defence. There is in fact before me an application by the Defendants dated 24 March 2003 for an order that they be granted permission under CPR Part 17 to amend their Defence in the respects set out in the draft attached to their Application Notice. The amendments relate, in part, to whether the loss claimed by Pirelli fell within the terms and conditions of the original contract of insurance and the contract of reinsurance and, in part, to whether in settling the claim, Generali took all proper and businesslike steps. On behalf of Generali, Mr. Hofmeyr indicated that he would not oppose the application if his primary and secondary arguments on construction were rejected. Those two arguments have been rejected. However, it seems to me on re-reading the proposed amendments that, in view of the decision to which I have come on the proper construction of the contract of reinsurance, it may be questionable whether all of the proposed amendments should be permitted. I shall therefore defer making any decision on the Defendants' application until the parties have had the opportunity of reading this judgment and, if they are so advised, addressing me further on the application. I shall, in any event, welcome the assistance of counsel on the terms of the appropriate declaration that follows from my judgment, the drawing up of the order, all issues of costs, and such other directions as they might consider appropriate.

Mr. Stephen Hofmeyr QC & Mr. John Bignall (instructed by Holman Fenwick & Willan) for the Claimant
Miss Sioban Healy (instructed by Hill Taylor Dickinson) for the Defendants