

## Negligent Reinsureds – A Defence for Reinsurers?

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- 1 A striking feature of English common law over the last fifty years has been what Tony Weir described as “*the staggering march of negligence*”<sup>1</sup>, the concept having encroached upon almost every aspect of the law of obligations. Lord Templeman decried this tendency, stating:

*“the tort of negligence has not yet subsumed all torts and does not supplant the principles of equity or contradict contractual promises or complement the remedy of judicial review or supplant statutory rights”*<sup>2</sup>.

- 2 The purpose of this talk is to consider, and in appropriate contexts question, the quiet invasion of the realm of insurance law by the concept of negligence, and the extent to which it has succeeded or failed.

### A What the insured knows: sections 18 to 19 MIA 1906

- 3 Disclosure in a pre-contractual setting does not depend, overtly at least, on care but on good faith. As Hoffman LJ observed in SAIL v. Farex<sup>3</sup>, however, the obligations set down in sections 18 to 20 are “*far from any ordinary understanding of lack of good faith*”. The obligations are as follows:

- a) Section 18 requires an insured to disclose “*every material circumstance which is known to the assured, and the assured is deemed to know every*

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<sup>1</sup> Tony Weir, ‘The Staggering March of Negligence’ in Peter Cane and Jane Stapleton, ‘The Law of Obligations: Essays in Celebration of John Fleming’ (Oxford, 1998).

<sup>2</sup> China and South Sea Bank v. Tan [1989] 3 All E.R. 839 at p.841.

<sup>3</sup> (1994) CLC 1,094 at 1,111. (for similar observations see La Banque Financiere de la Cite v. Westgate [1988] 2 Lloyd's Rep. 513 at p.545.

*circumstance which, in the ordinary course of business, ought to be known to him”;*

- b) Section 19 requires the agent to insure to disclose “*every material circumstance which is known to himself, and an agent to insure is deemed to know every circumstance which in the ordinary course ought to be known by, or have been communicated to, him*”.
- 4 The language “*ought to be known to him*” inevitably provides scope for the operation of concepts of negligence, premised on arguments that had the insured run his business properly, he would have ascertained the relevant facts. A common argument in reinsurance avoidance disputes is that the reinsured ought in the ordinary course of business to have ascertained particular facts about an underwriting agent, or an underlying risk or even about the risks of aggregation in its own business.
- 5 How far has this argument succeeded ?
- a) In Simner v. New India Assurance Co. Ltd.<sup>4</sup>, a stop loss reinsurance treaty had been written covering policies issued under a binder insuring local authorities against losses caused by the absence of teachers due to illness and injury. The reinsurer was told that no loss figures were available because the facility was a new one. An ominous claim had become apparent before the slip was signed, but this was not known to the reinsured or the reinsurance brokers, only to the holders of the binding authority. HHJ Diamond QC rejected the allegation that the reinsured owed the reinsurer a duty of care to go out and acquire the information:

*“Neither the 1906 Act nor authority suggests that, to make a fair presentation, the assured is under a duty to make enquiries or investigations as to facts outside his knowledge.*

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<sup>4</sup> [1995] LRLR 240.

*An assured is under no duty of care not to cause financial loss to the insurer. He is under no duty to advise the insurer whether or not to write the risk. The insurer is presumed to know his own business and to be capable for forming his own judgment as to the risk presented to him. The submission that an assured is under a duty to investigate matters outside his own knowledge for the purpose of making a fair presentation to the insurer would, as it seems to me, conflict with some if not all of these elementary propositions ”<sup>5</sup>.*

- b) HHJ Diamond QC drew powerful support from the judgment of McNair J. in Australia & New Zealand Bank v. Colonial & Eagle Wharves Ltd<sup>6</sup>. An insurer alleged that the insurer’s board of directors ought to have made enquiries which would have revealed that goods held by the company to the order of a bank were habitually delivered without the bank’s consent. McNair J rejected the allegation that this known to the insured “in the ordinary course of business”:

*“The submission that the board of the defendant company ought to have known the material facts because they would have known them if they had made enquiries as to their system as a reasonable, prudent board of such company in the ordinary course of business would have made, in my judgment fails ... I have been referred to no authority to suggest that the board of a company proposing to insure owe any duty to carry out a detailed investigation as to the manner in which the company’s operations are performed and I know of no principle of law which leads to that result ...*

*To impose such an obligation upon the proposer is tantamount to holding that insurers only insure persons who conduct their business prudently, whereas it is a commonplace that one of the purposes of insurance is to cover yourself against your own negligence or the negligence of your servants ”<sup>7</sup>.*

- c) A different approach appears from the judgment of Phillips J. in The Dora<sup>8</sup> in considering whether the owner of a yacht was fixed with

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<sup>5</sup> At p.252.

<sup>6</sup> [1960] 2 Lloyd’s Rep. 241

<sup>7</sup> At p.252.

<sup>8</sup> [1989] 1 Lloyd’s Rep. 69.

knowledge which he did not in fact have of a criminal conviction of the yacht's master. Phillips J held that there was "deemed knowledge" under s.18, remarking:

*"the sole business of the plaintiffs was to own and operate the Dora ... One of [the plaintiff's] most important duties ... was to appoint a properly qualified skipper. The normal course of business required him to check [the Master's] character. He made no such check ... I find that the plaintiffs had constructive knowledge of [the master's] criminal record"*<sup>9</sup>.

The commentary on this decision in Arnould, 'Law of Marine Insurance and Average'<sup>10</sup> states:

*"The case appears to go beyond any previous decision in this area. It may be that The Dora is to be explained on the basis that the ordinary course of business as conducted by the assured and their managing agent was for such inquiries to be made, but the decision comes close to suggesting (contrary to the view expressed in Arnould) that the relevant standard is simply an objective standard of negligence. The A&NZ Bank case does not appear to have been cited"*.

- d) However, Phillips J's approach is supported by Professor Clarke in 'The Law of Insurance Contracts' para. 23-8C:

*"It appears to be an objective test of what a business person of that kind ought to know ... While it is true that in principle cover extends to negligence by the insured, once the cover has been contracted, it does not follow that the insurer assumes the risk of negligence in the presentation of information on the basis of which the insurer will decide whether to take or how to rate the risk"*.

- 6 This issue can involve fine points of distinction. Clearly if the information is available to the insured, because it has reached his office or reached an agent of his whose duty it is to report it, it can be no answer that as result of negligence<sup>11</sup>

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<sup>9</sup> At p.95.

<sup>10</sup> 16<sup>th</sup> edition, Volume 3 (London, 1997) at para. 640, which contains an enlightening discussion of this difficult issue.

<sup>11</sup> The position in Aiken v. Stewart Wrightson Members Agency Ltd. [1995] 3 All E.R. 449.

or overwork<sup>12</sup> or simple dereliction of duty, the information has not reached the attention of the relevant (or indeed any) individual at the assured. This is a breakdown in the insured's own systems, operational rather than systemic negligence.

- 7 But it is another thing altogether to say that had the assured conducted his business in another way from the way he did conduct it, he would have acquired that information from a third party source: for example to allege that the insured should have maintained “agents to know” of a certain class, even if he did not in fact do so. Such an approach is an unwarranted intrusion of the concept of negligence into an area of law founded on good faith.
- 8 Finally, I would like to consider in this context a case of “disguised negligence” which often features in reinsurance disputes. A reinsurer discovers that the reinsured did not conduct its own business properly and alleges that this fact was not disclosed – for example a reinsured whose approach to underwriting business was generally careless ought to have disclosed that fact prior to placing whole account protections. Can it seek to avoid the reinsurance contract for the reinsured's failure to disclose his own negligent practices? There are difficulties with the submission that he can:
- a) First, a party does not “know” of his own negligence in the ordinary course of business: negligence is in its essence a judgment on conduct, not a fact, and individuals who are merely negligent, as opposed to subjectively reckless, are not generally conscious of their own failings.
  - b) Second, the proposition, taken to its logical development, is that reinsurers only insure competently run reinsureds. As McNair J observed of a similar argument in the Australian and New Zealand Bank case:

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<sup>12</sup> The facts of London and General Insurance Co. Ltd. v. General Marine Underwriters Association [1921] 1 K.B. 104.

*“the test of what ‘ought to be known’ by the assured is not, therefore, an objective test of what ought to be known by a prudent reasonable assured carrying on a business of the kind in question, but a test of what ought to be known by the assured in the ordinary course of carrying on his business in the manner in which he carries on that business; the underwriters take the risk that the business may be run inefficiently unless the circumstances are such that the assured knows or suspects facts material to be disclosed. To hold otherwise would be tantamount to saying that underwriters only insure those who conduct their business prudently; whereas it is a commonplace that one of the purposes of insurance is to obtain cover against the consequences of negligence in the management of the assured’s affairs”<sup>13</sup>.*

## **B Statements of belief or opinion: section 20 MIA 1906<sup>14</sup>**

- 9 Negligence has also reared its head when considering representations made under s.20 MIA 1906, where the issue of how far representations must be made on a reasonable basis has generated inconsistent case law. Like so many questions, the issue is best approached historically.
- 10 The common law did not originally treat opinions as representations at all, save as true statements of the opinion of the person making the misrepresentation<sup>15</sup>. There were occasions, however, where the matter on which the opinion was expressed was (as between the parties) peculiarly within the knowledge of the representor, when the statement of opinion would be treated as a representation that facts existed justifying the opinion<sup>16</sup>.

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<sup>13</sup> At p.254.

<sup>14</sup> I am grateful to Mr Tim Howe of Fountain Court for sharing his views on the ambit of Section 20(5).

<sup>15</sup> Reflected in Bowen LJ’s pithy dictum that the state of a man’s mind is as much a matter of fact as the state of his digestion: Edginton v. Fitzmaurice (1885) 29 Ch. D. 459 at 483.

<sup>16</sup> Eg. Smith v. Land and House Property Corporation (1884) 28 Ch. D. 7 at 15: “if the facts are not equally known to both sides, then a statement of opinion by one who knows the facts involves very often a statement of material fact, for he impliedly states that he knows facts which justify his opinion”. The common law was subsequently to develop this concept of an implied representation of reasonable grounds in cases such as Brown v. Raphael [[1958] Ch. 636; Bank Leumi v. British National Insurance Co. [1988] 1 Lloyd’s Rep. 71 at 75; Credit Lyonnais Bank Nederland v. Export Credit Guarantee Department [1996] 1 Lloyd’s Rep. 200.

11 Prior to MIA 1906, there was some recognition that a representation of opinion might contain this further representation. In Ionides v. Pacific (1871) LR 6 QB 674 an insured represented that the vessel carrying cargo was a new Norwegian vessel, whereas in fact it was an elderly French vessel of the same name.

Blackburn J. stated:

*“It was argued that a representation, if only as to an expectation or belief, is sufficiently complied with if the assured really had honestly entertained that expectation on sufficient grounds, and the representation that he thought the ship was Norwegian was literally true. We think this expression tantamount to an assertion that she was Norwegian; but even were it otherwise, the letter of advice, but for the carelessness of those who read it, would have made them aware that the ship was that of which the captain was Jean Card, and therefore the plaintiffs had no reasonable grounds for believing that she was the Norwegian ship”.*

12 However this was not the form in which the law relating to representations of opinion was to be encapsulated by Sir Mackenzie Chalmers his “Digest of Marine Insurance Cases”, nor in Section 20 of the MIA 1906. This provides:

- “(3) A representation may be either a representation as to a matter of fact, or as to a matter of expectation and belief.*
- (4) A representation as to a matter of fact is true, if it be substantially correct, that is to say, if the difference between what is represented and what is actually correct would not be considered material by a prudent insurer.*
- (5) A representation as to a matter of expectation or belief is true if it be made in good faith”.*

13 In Highlands Insurance Co. v. Continental Insurance Co.<sup>17</sup>, Steyn J. considered a representation made in the “Information” section in a reinsurance slip about the fire protections in the “Top Location” which was the subject-matter of the underlying insurance. The issue before the court whether this was merely a representation of what the reinsured believed, or had been told, or whether there was a representation of fact, or alternatively an implied representation that the reinsured had reasonable grounds for his belief. Steyn J actually decided the case on the former ground that the statement was clearly put forward as a statement of

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<sup>17</sup> [1987] 1 Lloyd’s Rep. 109.

fact, and as a subsidiary ground that the reinsured had not even been informed that the “Top Location” had sprinklers. He went on to consider the alternative ground, however, and held that if the statement was a statement of opinion or belief, it was impliedly represented that there were reasonable grounds for the belief.

- 14 In Economides v. Commercial Union Assurance Plc<sup>18</sup>, the Court of Appeal came to re-consider this issue in something of a different context. The value of property covered by a household insurance policy had been innocently under-stated in a household insurance, and the insurer sought to avoid on the basis that the insured had impliedly represented that he had reasonable grounds for his estimate of value (it being common ground that he did not). Simon Brown LJ expressly doubted Steyn J’s analysis<sup>19</sup>:

*“What then of Highlands, the case at the very forefront of Ms Kinsler’s submissions ? This passage too is, of course, obiter ... More to the point, however, is it correct ? Can one in an insurance context consistently with sect. 20(5) of the 1906 Act find in a representation of belief an implied representation that there are reasonable grounds for that belief ? In my judgment, not”.*

He was quick to distinguish between representations of fact disguised as representations of belief, which fell within s.20(4), and to record that for a belief to be honestly held, there must be *some* basis for it: it could not be plucked out of the air.

- 15 Peter Gibson LJ agreed<sup>20</sup>:

*“It is with considerable diffidence and unease that I differ from Steyn J’s analysis, albeit expressed obiter, in the Highlands case on this point in a field in which he has such great expertise. But the statutory test, consistent with the common law which sect. 20 enacted ... is one of good faith which is necessarily subjective, and*

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<sup>18</sup> [1998] Lloyd’s Rep. IR 9.

<sup>19</sup> At p.16.

<sup>20</sup> At p.21.

*I find it impossible to see how consistently with sect. 20(5) an objective test of reasonableness can be imported by way of an implied representation”.*

Sir Ian Glidewell did not decide the case on this basis, stating that he would wish to hear further argument on the point before deciding that Steyn J. was wrong.

- 16 The Economides case seems to constitute binding authority that a statement which is truly one of belief of expectation must be made in good faith only, and does not contain an implied representation that objectively reasonable grounds exist to support the belief<sup>21</sup>. But this is not how the case has been treated. In Sirius International Insurance Corporation v. Oriental<sup>22</sup>, Longmore J had to consider a factual situation which was very similar to that which had confronted Steyn J. 12 years before. The reinsured presented information to the reinsurers describing fire protections in property covered by the underlying policy. The information stated:

*“we have been informed that [hydrants] are applied as minimum standards for each location”.*

- 17 Longmore J. held that this was in truth a representation of fact that there were hydrants as the minimum standard of fire protection for each location, almost certainly correctly so. But he went on to consider the alternative issue of whether there was an implied representation of reasonable grounds if this were in truth merely a statement of belief and, following Highlands, held that there was such a representation. The basis on which Economides was distinguished is obscure<sup>23</sup>:

*“(1) ... the statement about hydrants must at least be a statement of belief and as such it must carry with it a statement that there were reasonable grounds for the belief;*

*(2) ... the existence of the hydrants is not a matter of opinion in the same way that a statement about value given ‘to the best of my/our knowledge and belief’ was held to be in Economides v. Commercial Assurance”.*

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<sup>21</sup> For an alternative interpretation see ‘MacGillivray on Insurance Law’ (10<sup>th</sup>) para.16-13.

<sup>22</sup> [1999] Lloyd’s Rep. IR 343.

18 In most cases, the answer to this difficulty will lie in the fact that a representation in a reinsurance context will often be one of fact, not opinion or belief: most communications in this context will be meant and understood as statements of how matters are, not merely as statements of the reinsured's opinion. Many other cases will be resolved in the business context by the fact that the matters which falsify the representation may be matters of which the reinsured should have been aware in the ordinary course of his business, in which case there would be an obligation to disclose under s.18. As Barlow, Lyde & Gilbert observe<sup>24</sup>:

*“Although some doubt has, therefore, been cast in this respect on Highlands v Continental, it may be that Economides v. Commercial Union will not have any practical impact on the conduct of the reinsurance market. The reason is that reinsureds are professionals who ought ‘in the ordinary course of business’ ... to make reasonable enquiries concerning any matter on which they state a belief in the course of a placement of a reinsurance contract. The decision in Economides may, therefore, be confined to ‘consumer’ insurance contracts”.*

19 But even in this context, there will be cases where statements of pure opinion are given – for example that “prospects are better for next year”; “we believe that the account is going to turn the corner”; “we expect this our war account to develop profitably”; “our underwriting philosophy is conservative”. It is difficult, consistent with s.20(5) MIA 1906, to imply a representation of reasonable grounds for the belief, even in a business context.

20 Two possible limits to the ambit of Section 20 should be noted:

- (1) The Section can only apply when the assured has correctly stated his expectation. If, through mistake or negligence, he has expressed an expectation which he does not in fact hold – to take a simple example, if an assured expressing an opinion on value mistyped the value he understood and intended to record - it is difficult to see how the reassured can avail himself of Section 20(5): he has not expressed his opinion.

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<sup>23</sup> At p.351.

- (2) Whilst Section 20(5) might entail that a statement of belief or expectation does not carry within it an *implied* representation of reasonable grounds for the belief, it is difficult to see why an assured could not *expressly* make such a representation. Once this is conceded, this may leave open the possibility in particular cases that such a representation is implicit in the particular circumstances in which a representation is made. Indeed it may entail that the issue of whether a secondary representation of reasonable grounds is made is not an issue of law, but an issue of the facts of particular cases. Economides may simply establish that a statement of expectation and belief does not *without more* carry with it a further implied representation.

## C Damages for negligence in placement

- 21 Amongst the many benefits of the film finance litigation is confirmation that damages for negligent misstatement in the course of placement are not generally available as between insured and insurer. In HIH Casualty & General Insurance Ltd. and ors v. Chase Manhattan Bank and ors<sup>25</sup> Aikens J held that there was no common law duty of care implicit in the relationship between reinsured and reinsurer. The Court of Appeal upheld Aikens J on this issue<sup>26</sup>, Rix LJ observing:

*“Insurance is a matter of risk; an insurer is either satisfied to be on risk or is not. If he discovers that he has been misled, he needs to make up his mind whether he is going to avoid the contract or not. He is put to his election. If, however, he has a remedy in damages as well, he could in theory waive his right to avoid without thereby waiving his right in damages. That would be a most unsatisfactory situation ...*

*As matters stand with the traditional remedy of avoidance, there is no need to consider whether a misrepresentation is negligent or not. Any material*

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<sup>24</sup> ‘Reinsurance Practice and the Law’ page 6-17.

<sup>25</sup> [2001] Lloyd’s Rep. IR 191 at 218.

<sup>26</sup> [2001] Lloyd’s Rep. IR. 667.

*misrepresentation within section 20 of the MIA 1906 will suffice. A duty of care on the other hand would invite litigation about the boundaries of negligence”<sup>27</sup>.*

22 In part for this reason, the Court of Appeal overturned Aikens J. on one issue where he had unwittingly furthered the attempted invasion of the law of insurance by negligence-based concepts. He had approached the ‘Truth of Statement’ clause in the line slip facility agreed between the parties, and in particular those elements of it which sought to restrict the subsequent rights of the reinsurers to set aside any contracts of insurance, by applying the principle of construction in Canada Steamship v The King<sup>28</sup> to be applied in ascertaining whether liability for negligence had been excluded. Following its own earlier judgment in HIH Casualty and General Insurance Limited v. New Hampshire<sup>29</sup>, the Court held:

*“Where the right to avoid is concerned ... the duty of good faith is unitary and absolute in the sense that breach of it does not depend on innocence or negligence, therefore it does not make sense to apply Lord Morton’s structured rules for presuming that the parties intended, if the language of the clause permits it, to concern themselves only with a cause of action which does not depend on negligence”<sup>30</sup>.*

23 One interesting issue may be noted in passing:

(1) First, whilst there does not appear to be any authority on the subject, it was accepted at first instance and on appeal in HIH that an insurer could claim damages from his insured under s.2(1) Misrepresentation Act 1967, in the event of a material misrepresentation having induced the contract. This was conceded before Aikens J. in HIH<sup>31</sup>, and had earlier been accepted by the Court of Appeal in Banque Keyser Ullmann<sup>32</sup>. The proposition is accepted by text-book writers as a correct statement of the law.

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<sup>27</sup> At paras.70-1/pages 722-3.

<sup>28</sup> [1952] A.C. 192.

<sup>29</sup> [2001] 2 All E.R. (Comm) 39, an appeal from David Steel J. reported at [2001] Lloyd’s Rep. IR 224.

<sup>30</sup> At para. 113/page 728.

<sup>31</sup> [2001] Lloyd’s IR 191 at 205.

<sup>32</sup> [1990] 1 Q.B. 665 at 789-90: the plea failed on the facts.

- (2) The claim under Section 2(1) is not so far removed from negligence (the taking of reasonable care providing a defence, albeit which the burden lies on the reinsured to establish rather than the insurer to rebut). In Gran Gelato Ltd. v. Richcliff (Group) Ltd. [1992] Ch. 560 at 673, the Vice Chancellor observed:

*“Thus in short liability under the Misrepresentation Act 1967 is essentially founded on negligence, in the sense that the representor did not have reasonable grounds to believe that the facts represented were true”.*

On this basis, the defence of contributory negligence under the Law Reform (Contributory Negligence) Act 1945 was essentially held to apply to a claim under the 1967 Act<sup>33</sup>.

- (3) Undoubtedly Section 20 MIA 1906 offers advantages to the reinsurer over Section 2(1) Misrepresentation Act 1967: there is no defence of reasonable grounds and the remedy of avoidance is automatically available (in circumstances in which damages might be limited to a differential in the premium which would otherwise have been payable rather than the insured loss eventually sustained). But Section 2(1) offers advantages as well: the apparent ability to recover consequential loss (for example the premium paid under facultative reinsurance taken out to cover the avoided risk; the costs of investigating the position), and the apparent ability to recover even when contract has been affirmed<sup>34</sup>. Given this, why is it, as Professor Clarke observes: (para. 21-15)

*“No case has been reported of an insurer recovering damages for misrepresentation or non-disclosure against his insured”.*

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<sup>33</sup> See also in Toomey v. Eagle Star (No. 2) [1995] 2 Lloyd’s Rep. 88 at 90, 93; HIH C&G Limited v. Chase Manhattan Bank [2001] Lloyd’s Rep. IR 703 at 729, 737. Although the duty was described as “absolute” in Howard Marine v. Ogden [1978] Q.B. 574 at p.596.

<sup>34</sup> There is no authority which suggests that a misrepresentee cannot elect to affirm the contract and sue for damages.

- (4) The answer must lie in our inherent assumption that damages for negligence – in whatever form - are not a remedy which should generally feature in the relationship of insured and insurer, and our sense, in Rix LJ's words, that it would be "*unsatisfactory*" if the reinsurer could both affirm and claim damages. However, the fact that liability under the Act for statements made without reasonable cause is automatic, rather than dependent upon the imposition of a duty of care, leaves limited scope for any judicial attempt to resolve the apparent discrepancy. Two difficult possibilities suggest themselves:
- (a) A reinsurer who is entitled to avoid will generally be able to escape any loss by doing so. If, with full knowledge, he chooses consciously to affirm the insurance contract, can it be argued that this conscious choice is the true cause of any loss under transaction?<sup>35</sup> It is very difficult to reconcile this argument with the law applicable to representations outside the field of insurance.
  - (b) Can it be argued that sections 18-20 MIA 1906 in effect create a complete code, and that the remedy of avoidance under s.20 is the sole remedy for misrepresentation? This would be a brave interpretation, although certain of the observations made in the Banque Keyser on s.17 precluding a claim for damages for non-disclosure may assist.

#### **D A duty of reasonable skill and care on the insured?**

- 24 Perhaps the most controversial attempt to introduce negligence concepts into reinsurance law is the attempt to impose some obligation on the reinsured's part to take objectively reasonable steps to avoid loss to the reinsurer.

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<sup>35</sup> It is difficult to reconcile this argument with the position in the law of misrepresentation generally, where rescission or damages are clearly alternative remedies available at the representee's election.

25 In the realm of direct insurance, this argument has generally failed, even in circumstances in which the policy contained language strikingly redolent of a duty to take care. The *locus classicus* on this issue was the Court of Appeal decision in Fraser v. Furman<sup>36</sup>, holding that a clause stating that “*the insured shall take reasonable precautions*” to avoid loss merely required the insured to abstain from deliberately and recklessly exposing himself to the risk of loss, the test being subjective rather than objective. Any other construction would have been wholly repugnant to the purpose of a liability policy. A similar ethos prevails in the construction of property policies, as evidenced by Sofi v Prudential Assurance<sup>37</sup>. The position finds express recognition in s.55(2)(a) MIA 1906:

*“The insurer is not liable for any loss attributable to the willful misconduct of the assured, but, unless the policy otherwise provides, he is liable for any loss proximately caused by a peril insured against, even though the loss would not have happened but for the misconduct or negligence of the master or crew”.*

26 In a reinsurance context, however, the idea that the reinsured is under a duty to exercise reasonable care in his underwriting to the reinsurer has recently gained ground, and a claim of breach of such a term features regularly in certain kinds of reinsurance dispute. The prediction of Robert Kiln – “*how long will it be before Reinsurers have yet another reason to repudiate contracts on the grounds of reckless or say incompetent underwriting*” – has sadly been fulfilled<sup>38</sup>.

27 The starting point appears to be Hobhouse J’s judgment in Phoenix v. Halvanon<sup>39</sup>, or more accurately a concession made before Hobhouse J of which he appears to have approved. The case concerned a facultative/obligatory treaty which, of course, gave the reinsured the unfettered right to cede (or not to cede) business to his reinsurer. The Judgment noted the pleading in the following terms:

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<sup>36</sup> [1967] 1 WLR 898.

<sup>37</sup> [1993] 2 Lloyd’s Rep. 591.

<sup>38</sup> Robert Kiln and Stephen Kill, ‘Reinsurance in Practice’ (4<sup>th</sup>) p.426.

<sup>39</sup> [1985] 2 Lloyd’s Rep. 599.

*“It was a term ... of the contracts implied in the express terms ...that [the reinsured] would conduct their business in accordance with the ordinary practice of the market and exercise due care and skill in the conduct of all business carried on under the ... contracts ... Those duties require [the reinsureds] inter alia to ...*

- (a) keep full and proper records and accounts of all risks accepted, or premiums received and receivable, and all claims made or notified;*
- (b) investigate all claims and confirm that they fall within the terms of the contract and were properly payable before accepting them;*
- (c) properly investigate risks offered to them before acceptance and closings relating thereto subsequently*
- (d) keep full and proper accurate accounts showing at all times the amounts due and payable by [the reinsureds] to the [reinsurer] and by [the reinsurer] to [the reinsureds] under the contracts;*
- (e) ensure that the amounts owing to them were collected promptly when due and entered forthwith in their accounts, and all balances owing to [the reinsurer] were likewise paid promptly when due;*
- (f) obtain, file or otherwise keep in a proper manner all accounting claims and other documents and records and make these reasonably available to [the reinsurer]”.*

28 Hobhouse J said<sup>40</sup>:

*“The implication of this term or terms was not controversial before me. Both witnesses thought them appropriate. Even though the opinion of the witnesses as to what is appropriate and reasonable does not suffice to show that such terms should be implied, I am satisfied that such terms are necessary in the present transactions. The facultative/obligatory nature of the transaction which imposes no restriction on the reassured’s right to choose whether or not to cede, without giving the reinsurer thereunder any equivalent right, does necessitate that the reinsured should accept the obligation to conduct the business involved in the cession prudently, reasonably and in accordance with the ordinary good practice of the market”.*

29 The justification to which Hobhouse J referred – the risk of adverse selection by the reinsured – would, it is submitted, be adequately addressed by an implied term of good faith, good faith, after all, being the foundation of insurance contracts. To say that it justifies an obligation on the reinsured not to write the underlying business negligently is, it is submitted, to go too far: for example, if the reinsured

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<sup>40</sup> At p.613.

owes a duty “*properly [to] investigate risks offered to them before acceptance*” does this mean he can be liable in damages for wrongly turning down profitable risks which would have been ceded to the reinsurer under the treaty, and which would have reduced the overall loss?

30 Nevertheless, the decision has been endorsed and enlarged upon.

- a) The passage has been approved and followed in Bermuda by Justice of Appeal George in In the matter of Chesapeake Insurance Co. Ltd.<sup>41</sup>.
- b) Hobhouse LJ endorsed, in passing, his own earlier judgment as a general statement of the implied terms appropriate to reinsurance in Toomey v. Eagle Star Insurance Co. Ltd.<sup>42</sup>:

*“Phoenix v. Halvanon deal[s] with the terms to be implied into such, and similar, types of contract in order to ensure that the interests of the reinsurers or those to whom risks are ceded, are sufficiently protected”.*

It is not clear from the last part of this sentence (“*or to those whom risks are ceded*”) whether Hobhouse LJ is intending to limit the operation of the implied terms to cases of **selective** cession by the reinsured (i.e. “*fac/oblig*”) or any form of treaty where the reinsurer is obliged to reinsure a share of what the reinsured writes (i.e. quota share and “*oblig/oblig*”).

- c) The editors of ‘MacGillivray on Insurance Law’<sup>43</sup> appear to lay the emphasis on selection:

*“[Halvanon] represents a significant and useful development of the law ... Item c) [the writing of risks] should apply to any treaty in which the reinsurer has bound himself to take business as ceded to him, and there is little or no restriction on the selection of cessions by the reinsured”.*

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<sup>41</sup> Bermuda Civ. App. No. 7 of 1991, 28 November 1991 (O’Neill para. 7-09).

<sup>42</sup> [1994] 1 Lloyd’s Rep. 516 at 523.

<sup>43</sup> London, 2003 para. 33-69.

The editors of Arnould also limit the term in this way<sup>44</sup>:

*“It has been held that terms are to be implied in a facultative/obligatory treaty that the reinsured should conduct the business involved with reasonable skill and care and in accordance with the ordinary practice of the market”.*

d) Others believe that the term should not be limited to cases of selection.

O’Neill and Woloniecki in ‘The Law of Reinsurance’ state<sup>45</sup>:

*“It is difficult to see why, following of Hobhouse J in Phoenix v. Halvanon the terms set out above should not be implied into every quota share treaty. Certainly a reinsured who expressly promised not to comply with such terms would find it difficult to obtain reinsurance”.*

e) Similarly the editors of Barlow, Lyde & Gilbert on ‘Reinsurance Practice and the Law’ state<sup>46</sup>:

*“It is likely that these obligations are of general application to treaty business and are not confined to facultative / obligatory contracts”.*

31 The only further judicial consideration of the issue of which I am aware is a decision of Tuckey J. in Economic Insurance Company Limited v. Le Assicurazioni d’Italia SPA<sup>47</sup>. The Economic through a cover holder wrote a bond to cover a contract for the supply and maintenance of vehicles, Economic’s assent being required before a risk would be written. Economic was reinsured by Assitalia. The terms of the reinsurance were complicated, but their effect was that Assitalia and the other reinsurers bore a proportionate share of every risk accepted by Economic. The bond had to be paid in full, and when Economic sought to recover Assitalia’s share, Assitalia raised by way of a defence that the bond had

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<sup>44</sup> Paras. 397-404 note 97.

<sup>45</sup> London, 1998 para. 7-10.

<sup>46</sup> At para. 15.3.1.

<sup>47</sup> 27<sup>th</sup> November 1996.

been negligently written in breach of an implied term to conduct the underlying business with reasonable skill and care.

- a) Economic argued that they owed no such duty to Assitalia: they themselves retained a retention, which gave them a common commercial interest in the risks written, and there was no process of selection by which they could determine which risks they would take on their own account and which they would reinsure.
- b) Assitalia relied on Phoenix v. Halvanon which they contended established the general position on reinsurance treaties.
- c) Tuckey J held that the duty fell to be implied in any case “*where the reinsurer is bound to accept cessions without the opportunity of exercising any independent underwriting judgment of his own*”. He noted that the reinsurance “*had all the essential characteristics of, say, a quota share, with Economic being bound to cede all but their retention and the reinsurers being bound to accept their proportion of all risks written by [the coverholder] on behalf of Economic*”. Nevertheless he held it was appropriate to imply the duty:

*“The fact that in Phoenix v Halvanon the reinsurers had no obligation to retain any part of the risk and had the right to choose which risks to cede made that case an a fortiori case for implication of the duty, but I do not think it follows that no duty should be implied in a case such as ours. In my judgment the fact that the reinsurers were bound to accept all business ceded to them made it necessary to imply a duty that Economic, acting through its agents CBF, would conduct the business prudently. This duty included a duty to investigate properly – that is to say, with reasonable skill and care – risks offered to them before acceptance”.*

- 32 It is submitted that the concept of a reinsured being under a duty of care owed to his reinsurers in relation his underwriting is a challenging one:

- (1) First, whilst this must necessarily involve speculation on the part of the lawyer, it is suggested that it is not the general perception of insurance professionals that they can review all risks written by their reinsureds, and defend a claim for losses on any risk written negligently on the grounds of circuity. Were this to be the general approach, it is surprising that the issue has remained so dormant for so long. Two well known market arbitrators, when presented with submissions on Phoenix and Assitalia made the following pertinent observations:

*“It would be surprising indeed if only two cases had come to the courts where a reinsurer had complained that his reinsured had ceded sub-standard business if there was an understanding in the market that a cedant’s right to cover could only be enforced if the risks had been underwritten in accordance with an implied standard. If this were to be accepted throughout the market, almost every unprofitable treaty would be subject to challenge ... In our opinion there would have to be exceptional reasons for an excess of loss reinsurer to be justified in declining to pay claims arising out of individual risks which were covered under the terms of a contract protecting a whole account”.*

Indeed were the term to be made out, a reinsurer would be better off in respect of business participated in by way of quota share than in respect of business which it wrote itself: it would be visited with the consequences of negligent underwriting in the latter case, but would effectively be guaranteed no “sub-standard” underwriting in the former case.

- (2) Second, it is difficult to reconcile the duty with s.55(2)(a) of the 1906 Act – *“unless the policy otherwise provides, [the insurer] is liable for any loss proximately caused by a peril insured against, even though the loss would not have happened but for the misconduct or negligence of the master or crew”*. This would suggest that the touchstone of breach should be recklessness rather than negligence: in the words of Diplock LJ in Fraser v. Furman [1967] 1 WLR 898 at 906: *“it must at least be reckless, that is to say, made with actual recognition by the insured himself that a danger exists and not caring whether or not it is averted”*, which falls within the

concept of “*wilful misconduct*” in S.55(2)(a): *NOW v. DOL* [1993] 2 Lloyd’s Rep. 582 (although the application of concepts of recklessness to the context of reinsurance is not without difficulty).

- (3) Third, in entering into a reinsurance contract, the reinsurer will have the right to a fair presentation of the risk, and the right to enquire as to what net retention the reinsured will be retaining. Thereafter, provided the reinsurer is protected by a duty of good faith in those cases where the reinsured has the right of selection of which risks are ceded, it is not “*necessary*” to imply into a reinsurance contract a duty on the reinsured’s part to exercise reasonable skill and care in the underlying business which it writes. There are many reasons why insurers buy reinsurance. They may include an expectation that some of the risks accepted may prove to be poor ones, and in respect of which the underwriting judgment has been shown to be wrong and may have been poorly exercised. A reinsurer will assess his reinsured, form a judgment of his operation, and thereafter, within the express terms of the policy, should follow his fortunes. As HHJ Diamond QC noted in *Simner v. New India Assce*<sup>48</sup>:

*“An assured is under no duty of care not to cause financial loss to the insurer. He is under no duty to advise the insurer whether or not to write the risk. The insurer is presumed to know his own business and to be capable of forming his own judgment as to the risk presented to him”.*

- (4) If the duty to take reasonable care does take hold, it is likely to generate a host of further issues:
- (a) The reinsured might, in turn, allege contributory negligence against his reinsurer if, for example, the latter has taken out insufficient retrocession protection against his exposure under the treaty (just

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<sup>48</sup> At p.253.

as contributory negligence defences based on “*excessive lending*” by building societies have been raised by negligent surveyors).

- (b) Issue may arise as to the *scope* of the duty of care owed, particularly with reference to the type of loss. For example, the “breach” may consist in accepting a risk at a premium which was too low, in circumstances in which the risk subsequently proves to be very unprofitable. Can the reinsurer argue that if care had been shown, the risk would not have been written at all and avoid all loss? Or is his loss limited to the effect of the “lost premium”? Again the surveyors’ negligence cases, and in particular the SAAMCo case<sup>49</sup>, may provide the answer.

#### **E Follow the settlement: proper and business like**

- 33 A context in which concepts of professional negligence has found a legitimate place in the realm of reinsurance is in considering “follow the settlement” clauses. These clauses escaped judicial consideration until the seminal decision in Insurance Co. of Africa v. S.C.O.R.<sup>50</sup>. In considering the scope of the clause, Leggatt J. rejected the suggestion that provided a claim fell on its face within the terms of the underlying policy and was settled in good faith, it was binding upon the reinsurer, and he imposed an additional requirement that “proper and business like steps” must have been taken in investigating and adjusting the claim (following, in this respect, the decision of Branson J. in Excess Liability v. Matthew<sup>51</sup>).
- 34 The decision was upheld by the Court of Appeal (although this approval was obiter, given the primary finding that the “follow settlements” clause was

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<sup>49</sup> South Australia Asset Management Corpn. v. York Montague [1997] A.C. 171.

<sup>50</sup> [1983] 1 Lloyd’s Rep. 541; [1985] 1 Lloyd’s Rep. 312.

<sup>51</sup> (1925) 31 Com. Cas. 43.

emasculated by the claims co-operation clause). Robert Goff LJ 'imported' the concept of professional negligence as follows:

*“In agreement with Mr Justice Bigham, I do consider that the clause presupposes that reinsurers are entitled to rely not merely upon 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 business-like manner”*<sup>52</sup>.

35 What does “proper and business like” mean ? Or to re-pose the question, how will the court determine whether there has been professional negligence in a reinsured’s handling of an inwards claims ? There are relatively few authorities:

(1) In Charman v. GRE<sup>53</sup> Webster J. held that the burden of proving a failure to exercise proper and business like steps lay on the reinsurer who sought to contend he was not obliged to follow the settlement.

*“There is a presumption that the reassured is entitled to call upon the reinsurer to follow his settlement, so that if an issue arises as to good faith or as to the fact that the settlement was made in a business-like fashion, the burden must lie upon the insurer”*.

On this issue he followed the judgment of JA Hunter in the Hong Kong case Insurance Company of the State of Pennsylvania v. Grand Union Insurance Co.<sup>54</sup>. He also held that it was not enough for the reinsured properly to appoint a loss adjuster, that he was to be identified with the conduct of the loss adjuster, and that he was required to give proper instructions and review the adjustment.

(2) A different consideration so far as the burden of proof is concerned was apparently reached by Evans J in Wurtembergische v. Home Insurance<sup>55</sup>,

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<sup>52</sup> At p.330.

<sup>53</sup> [1992] 2 Lloyd’s Rep. 607.

<sup>54</sup> [1990] 1 Lloyd’s Rep. 208.

<sup>55</sup> [1993] 2 Re. L.R. 253.

but the practical effect of this different approach appears to be minimal: he held that proof of a settlement in the ordinary course of business would give rise to a presumption that the settlement was binding on the reinsurer until the contrary was proven. That the burden of proof lies on the reinsurer has been confirmed by the judgment of Andrew Smith J in Gan v. Tai Ping (No. 3)<sup>56</sup>

- (3) The suggestion that the reinsured was identified with the conduct of the loss adjuster was approved, obiter, by Potter J in Baker v. Black Sea and Baltic<sup>57</sup>. However, it appears to be inconsistent with Leggatt J's judgment in SCOR where he stated:

*“It seems to me that there is a distinction between a careful ascertainment of a claim, which will doubtless include arranging for a proper process of adjustment to take place and, on the other hand, an adjustment careful in itself. I accept Mr Hunter’s submission that the latter would involve a warranty that the adjustment itself was carefully carried out, whereas there is nothing in the clause which would justify the implication of such a term”*<sup>58</sup>.

- (4) There are difficulties with the suggestion that the reinsured is liable for the day to day acts of the adjuster or obliged to follow him around as he does it. It is suggested that Charman and Baker are better understood as holding that the reinsured cannot wash his hands of responsibility by appointing a loss adjuster and slavishly following his recommendations, rather than as making the reinsured vicariously liable for any negligence of the loss adjuster.

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<sup>56</sup> [2001] Lloyd’s Rep. IR 667 at p.676.

<sup>57</sup> [1995] LRLR 261.

<sup>58</sup> [1983] 1 Lloyd’s Rep. 541 at p.555. Goff LJ had rejected the concept of any “higher duty” than one to take proper and business-like steps in the Court of Appeal: [1985] 1 Lloyd’s Rep. 312 at p.330. The appellants in SCOR argued that the insurers should have gone behind the adjustment.

- (5) A reinsured does not need his reinsurer's consent for any step he proposes to take in order for it to be proper and business-like: Gan v. Tai Ping (No. 3)<sup>59</sup>.
- (6) It is also suggested that although notionally a test of professional negligence, a reinsured is unlikely to be found to have failed to follow proper and business like steps provided the judgments reached by it fall within the range of reasonable opinions which reinsureds might take. Different views can often be taken of the best way to respond to a particular claim. Through the "follow settlements" clause, the reinsurer has agreed to follow the judgment of the reinsured, and the exercise of that judgment should not lightly be questioned.

36 In SCOR, however, the "proper and businesslike" obligation is not stated to be an independent term of the reinsurance which sounds in damages, but a *pre-condition* of the reinsured's right to recover in circumstances in which he might not otherwise be able to do so. Similarly, the Court of Appeal held that in Skandia v. NRG Victory<sup>60</sup> than even where there was no "follow the settlements" clause, a reinsurer was obliged to pay where his reinsured had been adjudged liable provided "all proper defences" were taken ("follow the judgments"). Once more the language is suggestive of a pre-condition, rather than an independent obligation.

37 The issue is best tested by the following example: can the reinsured who could have settled the case at a low sum, but negligently settles at a higher level, recover the full amount from his reinsurer by showing that he was *in fact* liable for the full sum? The failure to exercise "proper and businesslike steps" would appear to preclude recovery under the "follow the settlements" clause, but as Mance LJ

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<sup>59</sup> [2001] 1 Lloyd's Rep. IR 667 at 678.

<sup>60</sup> [1998] Lloyd's Rep. IR 439.

noted in Gan v. Tai Ping (Nos. 2 and 3)<sup>61</sup> the insured can establish he was *in fact* liable:

*“Both under the reinsurance in SCOR (UK) and at common law insurers could, if they wished, take the risk, still settle despite the lack of approval. This was not a breach of any condition precedent to reinsurers liability generally. It merely deprived insurers of the benefit of the ‘follow the settlements’ provision .... Having thus crystallised their exposure by the settlement, insurers could still go on to prove that it related to liability that had actually existed apart from the settlement”.*

38 Mance LJ rejected this option in the face of the express term in GAN and because he recognised that a reinsurer could be prejudiced even by the settlement of a claim for which the reinsured was in fact liable: *“merely because insurers might ultimately be able to prove that the claim was one for which they were liable in law does not mean that prompt advice to and co-operation with reinsurers might not have led to a more beneficial outcome”*. But an express term apart, it should be possible for a reinsured to recover the full amount of his settlement in these circumstances. Unless he is under a free-standing duty to act with reasonable skill and care in the handling of underlying losses, the reinsured is *prima facie* entitled to be indemnified against the liability which, on this hypothesis, he has incurred.

14 January 2003.

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<sup>61</sup> [2001] Lloyd’s Rep. IR 667 at 690.