

HOUSE OF LORDS

**OPINIONS OF THE LORDS OF APPEAL FOR JUDGMENT
IN THE CAUSE**

*CHARTER REINSURANCE COMPANY LIMITED
(PROVISIONAL LIQUIDATORS APPOINTED 23RD JUNE 1994)
(RESPONDENTS)*

v.

*FAGAN
(SUED ON BEHALF OF HIMSELF AND ON BEHALF
OF ALL OTHER MEMBERS OF LLOYD'S SYNDICATES 540 AND 542
FOR THE 1989 AND 1990 UNDERWRITING YEARS OF ACCOUNT)
(APPELLANT)*

ON 22ND MAY 1996

LORD GOFF OF CHIEVELEY

Lord Goff
of Chieveley
Lord Griffiths
Lord Browne-
Wilkinson
Lord Mustill
Lord Hoffmann

My Lords.

I have had the advantage of reading in draft the speech of my noble and learned friend Lord Mustill and for the reasons he gives I too would dismiss this appeal.

LORD GRIFFITHS

My Lords.

I have had the advantage of reading in draft the speech of my noble and learned friend Lord Mustill and for the reasons he gives I too would dismiss this appeal.

LORD BROWNE-WILKINSON

My Lords,

For the reasons given in the speech by my noble and learned friend Lord Mustill I too would dismiss this appeal.

LORD MUSTILL

My Lords,

This appeal turns on the meaning of the words "actually paid" in three contracts of reinsurance. The question is whether the words prescribe that no sum will be paid by reinsurer to reinsured in respect of a loss, or more accurately that no sum will be brought into the balance of account between the two parties, until the reinsured has paid out a sum of money to the person whose claim against him has brought the reinsurance into play. At first sight this seems the shortest of questions, requiring a very short answer: and so in the end it proves to be. But the instinctive response must be verified by studying the other terms of the contract, placed in the context of the factual and commercial background of the transaction. I will therefore go straight to the nature of the business and to the terms of the contract in which it was embodied, concentrating for the moment on only one of the three policies, namely policy no. X 20693/5386.

By this contract two syndicates, represented in these proceedings by Mr. P. F. Fagan ("the syndicates") reinsured for small percentages of a total line Charter Reinsurance Co. Ltd. ("Charter") in respect of Charter's whole account for losses occurring during the calendar year 1989. The contract formed part of a programme which also comprised "specific reinsurances" taken out with others on four of Charter's accounts viz., Non-Marine LMX; Non-Marine International; Marine; and Aviation. These accounts were reinsured in a series of tranches to limits of, respectively, £23m., £11m., £32.25m. and £31.5m. Above these reinsurances of separate accounts were the levels of whole account reinsurance with which two of the three contracts in suit were concerned. Above a retention of £100,000. there were successive layers of £2.9m., £2m., £2.5m. and £2.5m. Policy no. 5386 insured the second of these layers, for £2m. excess of £3m. and one of the other policies sued upon covered the fourth layer up to £7.5m. For the purposes of the present litigation it is assumed that a series of major casualties arising from perils insured under the policy have caused valid claims to be made against Charter under policies issued by it to other reinsured or insured companies or syndicates ("the inward policies"). These claims are so large as to exhaust all the reinsurances comprising the specific accounts of the programme, and to encroach upon the relevant layers of whole account reinsurance. The problem

arises from the fact that Charter is in provisional liquidation, being unable to pay its debts as they fall due, and these debts include claims under the inward policies. For their part, the syndicates do not for present purposes dispute that all the requirements of a valid claim against them by Charter are present, save only one: that Charter have not paid, and cannot pay, the inward claims which they have reinsured. Thus, say the syndicates, Charter have no cause of action under the reinsurance.

The practical importance of this defence, if sound, is obvious; and its implications have been multiplied by the levels of financial frailty experienced in the London insurance market in recent years. Across the market as a whole very large sums depend upon it, and the litigation from which this appeal stems has been brought in practice, if not in form, as a test case. The proceedings take the shape of an action by Charter for a summary declaration that payment by way of transfer of funds or other means of satisfaction by Charter under the inward policies was not a condition precedent to the liability of the syndicates. Within a very few months it proved possible to obtain the opinion of the Commercial Court in the shape of a meticulous and thoughtful judgment of Mance J., granting a declaration in those terms. Upon recourse to the Court of Appeal this decision was upheld by a majority, Staughton L.J. dissenting. The syndicates now appeal to this House.

This being, I believe, a sufficient summary of the dispute I turn to policy no. X 20693/5381. It is important to quote its terms at some length.

For ease of reference I have added numbers and letters, and have placed in italics the words around which the controversy revolves.

"1. REINSURANCE CLAUSE

This Reinsurance is to pay all losses howsoever and wheresoever arising during the period of this Reinsurance on any Interest under Policies and/or Contracts of Insurance and/or Reinsurance underwritten by the Reinsured in their Whole Account.

Subject however to the following terms and conditions.

"2. (a) LIABILITY CLAUSE

The Reinsurers shall only be liable if and when the Ultimate Net Loss sustained by the Reinsured in respect of interest coming within the scope of the Reinsuring Clause exceeds £3,000,000 or U.S. or Can. \$6,000,000 each and every loss and/or Catastrophe and/or Calamity and/or Occurrence and/or Series of Occurrences arising out of one event and the Reinsurers shall thereupon become liable for the amount in excess thereof in each

and every loss, but their liability hereunder is limited to £2,000,000 or U.S. or Can. \$4,000,000 each and every loss and/or Catastrophe and/or Calamity and/or Occurrence and/or Series of Occurrences arising out of one event.

- (b) WARRANTED Reinsurers hereon to have benefit of Specific Reinsurances as per Schedule attached.

ULTIMATE NET LOSS CLAUSE

- (c) *The term 'Net Loss' shall mean the sum actually paid by the Reinsured in settlement of losses or liability after making deductions for all recoveries, all salvages and all claims upon other Reinsurances whether collected or not and shall include all adjustment expenses arising from the settlement of claims other than the salaries of employees and the office expenses of the Reinsured.*
- (d) All Salvages, Recoveries or Payments recovered or received subsequent to a loss settlement under this Reinsurance shall be applied as if recovered or received prior to the aforesaid settlement and all necessary adjustments shall be made by the parties hereto. Provided always that nothing in this clause shall be construed to mean that losses under this Reinsurance are not recoverable until the Reinsured's Ultimate Net Loss has been ascertained.
- (e) Notwithstanding anything contained herein to the contrary, it is understood and agreed that recoveries under all Underlying Excess Reinsurance Treaties and/or Contracts (as far as applicable) are for the sole benefit of the Reinsured and shall not be taken into account in computing the Ultimate Net Loss or Losses in excess of which this Reinsurance attaches nor in any way prejudice the Reinsured's right of recovery hereunder.

"3. PERIOD OF REINSURANCE CLAUSE

This Reinsurance covers Losses Occurring during the period commencing with the 1st January, 1989 and ending with the 31st December, 1989 both days inclusive, Local Standard time at the place where the loss occurs.

"4. PREMIUM CLAUSE

The Minimum and Deposit Premium for this Reinsurance shall be U.S.\$600,000.00

10% Payable in Sterling, namely £37,500.00 89½% Payable in U.S. Dollars, namely \$537,000.00 ½% Payable in Can. Dollars, namely \$3,000.00. . .

"5. CURRENCY CLAUSE

Losses (if any) paid by the Reinsured in currencies other than Sterling, shall be converted into Sterling at the rate of exchange ruling at the date of the settlement of loss or losses by the Reinsured other than losses paid in U.S. or Can. Dollars which will be paid in those currencies.

"6. REINSTATEMENT CLAUSE

In the event of loss or losses occurring under this Reinsurance, it is hereby mutually agreed to reinstate this Reinsurance to its full amount of £2,000,000 or U.S. or Can. \$4,000,000 from the time of the occurrence of such loss or losses to expiry of this Reinsurance and that an additional premium shall be paid by the Reinsured upon the amount of such loss or losses when they are settled in the first instance calculated at 100% of the Minimum and Deposit Premium hereunder subject to a further payment hereunder (if any) when the Final Earned Premium is known. Reinstatement premiums to be paid in the currency of loss settlement hereunder for which purpose U.S. or Can. \$1.60 = £1.

Nevertheless the Reinsurers shall never be liable for more than £2,000,000 or U.S. or Can. \$4,000,000 in respect of any one loss and/or series of losses arising out of one event, nor for more than £6,000,000 or U.S. or Can. \$12,000,000 in all."

The case for the appellants concentrates almost exclusively on the words in italics. It is very simple. These words plainly create a condition precedent to any liability of the syndicates. The condition is that Charter shall have "actually paid" under the original policies. If this expression has a natural and ordinary meaning, effect should be given to it. The expression and the words which comprise it do have such a meaning. By no stretch of language can it be extended to cover a situation in which Charter has not made any disbursement, actual or even notional, and will never do so.

My Lords, to a substantial degree I accept this argument. I believe that most expressions do have a natural meaning, in the sense of their primary meaning in ordinary speech. Certainly, there are occasions where direct

recourse to such a meaning is inappropriate. Thus, the word may come from a specialist vocabulary and have no significance in ordinary speech. Or it may have one meaning in common speech and another in a specialist vocabulary; and the context may show that the author of the document in which it appears intended it to be understood in the latter sense. Subject to this, however, the enquiry will start, and usually finish, by asking what is the ordinary meaning of the words used. I begin, therefore with "actually". In my opinion this word is used by way of qualification or precaution, in the sense of "really", "in truth", "not notionally" or "not prospectively". On this, I feel no doubts. The word "paid" is more slippery. Unquestionably, it is no longer confined to the delivery of cash or its equivalent. In ordinary speech it now embraces transactions which involve the crediting and debiting of accounts by electronic means, not only transfers between bank accounts by payment cards and direct debits, but also dealings with credit cards and similar instruments. Conditional payment by cheque would also be covered, at any rate outside a strictly legal context. Furthermore, I think it plain that in a document created to govern a transaction in the London insurance market payment would extend beyond remittances from debtor to creditor and would include the settlements in account with brokers which are a feature of that market. None the less, even giving "paid" an extended meaning the word would at first sight, and even without the qualifier "actually", fall well short of encompassing a situation in which the debtor had suffered no immediate financial detriment through a transfer of funds in the direction of the creditor, and would never do so.

My Lords, I have used the expression "at first sight" because I had initially thought that the meaning of the words was quite clear, and that the complexities and mysteries of this specialist market had hidden the obvious solution, and had led the courts below to abjure the simple and right answer and to force on the words a meaning which they could not possibly bear. I was not deflected from this opinion by any of the cases cited, which with few exceptions (to which I must return) seemed too remote from the present to offer any useful guidance.

This is, however, an occasion when a first impression and a simple answer no longer seem the best, for I recognise now that the focus of the argument is too narrow. The words must be set in the landscape of the instrument as a whole. Once this is done the shape of the policy, and the purpose of the terms which I have grouped as clause 2 become quite clear. As one would expect, four essential features of the insurance are described: the perils insured against; the measure of indemnity; the duration of the cover; and the premium. Clause 1, read together with various later clauses of enlargement and restriction, which I have not quoted, describes the nature and geographical scope of the perils insured against. In principle, all events happening within the period laid down by clause 3 (construed in association with special provisions relating to liability insurance) which constitute losses by perils insured under the original policies are to be losses insured under this policy. This is not the place to discuss the question, perhaps not yet finally

resolved. whether there can be cases where a contract of reinsurance is an insurance of the reinsurer's liability under the inward policy or whether it is always an insurance on the original subject-matter, the liability of the reinsured serving merely to give him an insurable interest. This may be important in the context of regulation, but it makes no difference here, for it is quite plain that payment by reinsurer is not the insured event. There has still been an insured loss, and even if the argument for the syndicates is right the consequence is only to reduce or eliminate the amount of Charter's recovery under clause 2 in respect of a loss which has undoubtedly occurred. Clause 1 therefore has no bearing on the present dispute. Nor of course is the premium provision in clause 4 of any relevance.

What does matter is the group of provisions which establish the measure of indemnity, once a loss by an insured peril has taken place. I would break these down as follows:

- (i) Clause 2(a) fixes the level at which financial prejudice suffered by Charter under the inward policies in consequence of a loss by a peril insured under this policy causes a liability to attach. This happens when the ultimate net loss in relation to each and every loss and/or catastrophe and/or calamity and/or occurrence (which I will call a set of linked losses) exceeds £3,000,000. This sub-clause also fixes the upper limit of indemnity under the policy. An additional limit, this time fixed by reference not to each set of linked losses but to the cover for the entire policy year, is imposed by the last sentence of clause 6.
- (ii) Clause 2(b) incorporates into the scheme of the policy the four sets of layered "specific" insurances (i.e. the "accounts") identified in the schedule. When an event occurs which is a peril insured under one of those sets of insurances and also under this policy the limits of all the insurances comprising that account must be exceeded before any indemnity begins to fall due under this policy.
- (iii) Clause 2(c) gives meaning to clause 2(a) by defining ultimate net loss. (In fact the sub-clause omits "ultimate". This must be a mistake, for otherwise the entire group of provisions makes no sense. The word does appear in the clause as typed in the aviation policy). The purpose of clause 2(c) is to make clear that the syndicates are not to pay losses gross, but that there is to be a netting-down for recoveries, salvage and the like when ascertaining whether, and if so by how much, the relevant liabilities of Charter cross the boundary into the layer covered by this policy.
- (iv) The first sentence of clause 2(d) elaborates clause 2(c) by making clear that the fixing of an ultimate net loss in respect of any set of linked losses is provisional, in the sense that the amount of it, and hence its impact if any on this layer of insurance, is to be open to re-

computation if and when items of the identified description subsequently accrue to the benefit of Charter.

(v) The proviso in the second sentence of clause 2(d) emphasises that even though the computation of an ultimate net loss is provisional, if it yields a figure broaching the bottom of the layer insured under this policy it will then be "recoverable" even if a subsequent recalculation when all the figures are in may lead to an upward or downward adjustment, or even to the elimination of any recovery at all.

(vi) Clause 2(e) is puzzling at first sight, because the use of initial capitals may suggest that, like "Specific Insurances" in clause 2(b), the expression "Underlying Excess Reinsurance Treaties and/or Contracts" has a meaning specifically ascribed for the purpose of this policy. Yet one finds it nowhere defined. In fact, however, a reading of the document as a whole shows that capitals are used indiscriminately throughout, and that they have no special significance in clause 2(e). In the light of the explanations given in argument, I accept that the purpose of the sub-clause is simply to ensure that the calculation of the ultimate net loss under sub-clause (a) does not involve a deduction of the liabilities on the underlying layers, so as to diminish the possibility of a recovery on the layer covered by this policy.

Analysed in this way, the policy makes complete sense, and works perfectly well in practice when understood as requiring the satisfaction of only two conditions before an indemnity falls due. First, that an insured event shall have occurred within the period of the policy, and second that the event shall have produced a loss to Charter of a degree sufficient, when ultimately worked out, to bring the particular layer of reinsurance into play. This reading accommodates without strain the words "if and when", in clause 2(a); for they are concerned only with the point, not of time but of arithmetic, at which the figures for the ultimate net loss reach the appropriate level. Equally, I am now satisfied that the purpose of "the sum actually paid" in clause 2(c) is not to impose an additional condition precedent in relation to the disbursement of funds, but to emphasise that it is the ultimate outcome of the net loss calculation which determines the final liability of the syndicates under the policy. In this context, "actually" means "in the event when finally ascertained", and "paid" means "exposed to liability as a result of the loss insured under clause 1". These are far from the ordinary meanings of the words, and they may be far from the meanings which they would have had in other policies, and particularly in first-tier policies of reinsurance. But we are called upon to interpret them in a very specialised form of reinsurance, and I am now satisfied that, as Mance J. expressed it in his judgment at first instance, the words in question did not have the purpose of introducing a temporal pre-condition to recovery in the form of disbursement or other satisfaction of the precise net commitment between Charter and its reinsured, but were there "for the purpose of measurement".

Whilst I have come to this conclusion simply from a study of the document I ought to comment on a number of other matters which are said to bear upon it. In the first place, there is an argument *ad absurdum* to the effect that the parties cannot have intended Charter to retain such liquidity as would enable it to answer claims under the incoming policies without recourse to the reinsurance. At a time when the use of money was a vital element in the profitability of insurance business it is impossible to suppose (the argument runs) that Charter should have agreed to finance its own outlays, the more so since, if the syndicates' interpretation of clause 2 is right, Charter would have to find, not only the funds required to disburse the sum due under this particular layer, but also the total of the underlying reinsurances. This would be a wholly impracticable arrangement, and would bear especially hard on Charter if it fell into financial trouble and lacked the means to make the payments necessary to unlock the reimbursements due under its contracts with the syndicates.

This argument draws strength from the shape of the policy. As I have already suggested, under this form of words, although perhaps not under all forms, the policy covers not, as might be thought, the suffering of loss by the reinsured in the shape of a claim against him under the inward policies, but the occurrence of a casualty suffered by the subject-matter insured through the operation of an insured peril. The inward policies and the reinsurance are wholly distinct. It follows that in principle the liability of the reinsurer is wholly unaffected by whether the reinsured has satisfied the claim under the inward insurance: see, amongst several authorities, *In re Eddystone Marine Insurance Co., Ex parte Western Insurance Co.* [1892] Ch. 423. This result can undoubtedly be changed by express provision, but clear words would be required; and it would to my mind be strange if a term changing so fundamentally the financial structure of the relationship were to be buried in a provision such as clause 2, concerned essentially with the measure of indemnity, rather than being given a prominent position on its own.

Further arguments, to my mind some way short of conclusive, were advanced on each side. The syndicates pointed out a possible disconformity between the postponement of the reinsurers' liability to pay with the statutory provisions governing margins of solvency. For Charter attention was drawn to long-established contractual provisions creating just such a condition precedent as is argued for here: for example, in the running down clause and in protection and indemnity club cover against third party liabilities, the effect of which was discussed in *Firma C-Trade v. Newcastle P & I Association* [1990] 2 Lloyd's Rep. 191. Each side suggested reasons why such a provision would or would not make commercial sense; and proposed ways in which the hardship to the reinsured might be ameliorated by devices such as the making of a series of small "pump priming" payments, which would produce a sufficient trickle of cash to satisfy ultimately the inward claim in full, hence unlocking a recovery under the reinsurance.

These arguments are fully explored in the judgments delivered below. Intending no disrespect I do not enter into them here. for in my opinion they cannot be decisive. If, as I believe, a proper reading of the policy discloses no condition precedent, there is little profit in considering whether it would have been absurd to include one. If, per contra, the words "actually paid" can only as a matter of language and context mean what the syndicates maintain, I would hesitate long before giving them any other meaning, just because the result would be extraordinary. The words of Lord Reid in *Wickman Machine Tool Sales Ltd. v. Schuler A.G.* [1947] A.C. 235, 251 do of course reflect not only a method of constructing contracts but also the common experience of how language is understood:

"The fact that a particular construction leads to a very unreasonable result must be a relevant consideration. The more unreasonable the result the more unlikely it is that the parties can have intended it, and if they do intend it the more necessary it is that they shall make that intention abundantly clear."

This practical rule of thumb (if I may so describe it without disrespect) must however have its limits. There comes a point at which the court should remind itself that the task is to discover what the parties meant from what they have said, and that to force upon the words a meaning which they cannot fairly bear is to substitute for the bargain actually made one which the court believes could better have been made. This is an illegitimate role for a court. Particularly in the field of commerce, where the parties need to know what they must do and what they can insist on not doing, it is essential for them to be confident that they can rely on the court to enforce their contract according to its terms. Certainly, if in the present case the result of finding a condition precedent would be anomalous there would be good reason for the court to look twice, and more than twice, at the words used to see whether they might bear some other meaning. In the end, however, the parties must be held to their bargain. Thus, if I had adhered to my first impression that the expression "actually paid" could possess, even in the context of the policy, only the meaning which it has in ordinary speech I would have wished to consider very carefully whether the opinion expressed in the dissenting judgment of Staughton L.J., austere as it might seem, ought to be preferred. In the event however, for the reasons stated, this is not my present understanding of the words, and since the broader question does not on this view arise I prefer to say no more about it.

Next, I must notice three decisions from the United States. The first is *Allemannia Insurance Co. of Pittsburgh v. Firemen's Insurance Co. of Baltimore* (1908) 209 U.S. 326. A proportionate policy of reinsurance stipulated (p. 332) that:

"11. Each entry under this compact . . . shall be subject to the same conditions, stipulations, risks and valuations as may be assumed by the said reinsured company under its original contracts hereunder

reinsured, and losses, if any, shall be payable pro rata with, in the same manner, and upon the same terms and conditions as paid by the said reinsured company under its contracts hereunder reinsured, and in no event shall this company be liable for an amount in excess of a ratable proportion of the sum actually paid to the assured or reinsured "

After the great fire in Baltimore of 1904 the direct insurer became insolvent and could not pay more than 55 cents in the dollar, and therefore was unable to satisfy claims under its policies unless it could first recover from the reinsurer. The Supreme Court of the United States held that payment by the reinsured was not a condition of recovery under the reinsurance. Delivering the opinion of the Court Peckham J. stated, at p 336:

"We agree with the court below, that the language of the eleventh subdivision, taken in connection with the fact that it is used in a contract designated by the parties as one of reinsurance, means that the reinsuring company shall not pay more than its ratable proportion of the actual liability payable on the part of the reinsured, after deducting all liability of other reinsurers. To hold otherwise is to utterly subvert the original meaning of the term reinsurance and to deprive the contract of its chief value. The losses are to be payable pro rata with, in the same manner and upon the same terms and conditions as paid by the reinsured company under its contracts. This means that such losses, payable pro rata, are to be paid upon the same condition as are the losses of the insurer under its contract . . . [This] . . . does not mean there must be an actual payment of such liability by the insurer before it can have any benefit of the contract of reinsurance which is made with defendant."

In the second case, *Fidelity and Deposit Co. v. Pink* (1937) 302 U.S. 224 the contract was in very different terms. It stipulated that the reinsurer's proportionate share of the loss should be paid to the reinsured upon proof of payment by the reinsured, and on tender of documents in support. It was furthermore stipulated that the reinsured might give the reinsurer prospective notice of its intention to pay on a certain date, and might require the reinsurer to put its share of the loss in the hands of the reinsured by that date. Distinguishing the *Allemannia* case, without differing from the statement of general principle therein contained, the Supreme Court held that on this occasion the contract was effective to make prior payment a condition payment to liability.

Finally, in *Stickel v. Excess Insurance Co. of America* (1939) 23 N.E. 2d 839, an ultimate net loss clause defined that term (p. 841) as "the sum actually paid in cash in settlement of losses for which the company is liable, after making proper deductions" Founding on the language of the particular policy in question, the Supreme Court of Ohio found the case closer

to *Pink* than to *Allemannia*, and held that once again actual disbursement was a condition precedent to recovery.

There was some suggestion in argument that there is an inconsistency between these cases. On examination I can detect none. Even the brief account given above is sufficient to make the individual decisions perfectly understandable. Whether they were all right it is unnecessary and inappropriate to consider; and it is of course true that the *Allemannia* case 209 U.S. 326 was concerned with proportionate insurance, whereas the present is not. What it is permissible to say however is that the brief statement of general principle in that case accords with the law as it has been understood for many years, in common law jurisdictions and elsewhere. I can see nothing in these cases to cast doubt on the opinion which I have expressed as to the effect of the present policy.

Finally, there are the inferences about the purpose of the words "actually paid" which may be drawn from the history of the "follow settlements" clause. The matter is fully developed in the speech of my noble and learned friend Lord Hoffmann. If I own to hesitation in adopting this as a direct answer to the problem it is because the historical materials presented in argument are incomplete, and subsequent reading has not filled the gaps. It is however clear that in the long time-frame of the insurance industry excess of loss reinsurance is comparatively modern, probably dating from transactions arranged by C.E. Heath in the United States in the last two decades of the 19th century. It was not until after the Baltimore fire that the need for an excess of loss non-proportionate cover written on a treaty basis became obvious. Such cover would of course need to provide for a means of ascertaining the point at which the reinsurance (or its first layer) attached: equally important however, was that this determined the amount of the reinsured's retention, always a matter of prime importance when writing reinsurance. I think it a reasonable surmise that this retention was expressed in terms of net rather than gross. It is likely therefore that there was from the start some form of ultimate net loss clause in American excess of loss policies. Given that the *Allemannia* proportional reinsurance, effected in 1903, already included these words, I think it as likely that they were simply copied into excess of loss policies, as that they were deliberately included to combat a puzzling English decision some 20 years old, not referred to at all in the report of the *Allemannia* case, and not yet the subject of acute controversy even in England. This is however surmise but it is possible to say with some confidence that there is nothing in the available history to suggest that the words "actually paid" were and are included in order to create a condition precedent.

There is one final point, directed to the wording of this particular policy. It will be recalled that clause 2(c) defined net loss as ". . . the sum actually paid . . . after making deductions for all recoveries [etc] whether collected or not" There is a discontinuity here, if the syndicates are right. There is good reason why the provisional ascertainment of the effect

which the losses will have on the reinsured layer should be made in the light of forecasts about the funds which will be transferred out, and the funds which will be transferred in, on future occasions before the ultimate net loss is finally ascertained, but I can see no reason why uncollected funds should be used as a contra sum at a time when through the absence of payment under the inward policies there is nothing against which to set them. Here again, I do not regard the point as conclusive, but it does reinforce the solution at which I have independently arrived.

For these reasons therefore I consider that the interpretation given by Mance J., and Simon Brown L.J. to policy no. X 20693/5386 was correct. This makes it unnecessary to consider the alternative line of reasoning which led Nourse L.J. to conclude in favour of Charter. The position under the second policy is acknowledged to be the same.

There remains the aviation policy. There are differences between this and the first two policies which might for other purposes be important. Mance J. has drawn attention to some of them. But in my opinion none of them bear on the present dispute, and the reasoning which I have proposed applies equally to all three contracts.

In these circumstances I would dismiss the appeal.

LORD HOFFMANN

My Lords,

This appeal turns upon the construction of a standard clause known as the ultimate net loss ("UNL") clause which is in common use in the London excess of loss reinsurance market. Although the action concerns three particular policies of reinsurance written on behalf of two Lloyd's syndicates, it raises an issue which affects the whole reinsurance market.

The relevant provisions are set out in the speech of my noble and learned friend Lord Mustill and I need not repeat them. The question is whether the words "actually paid" mean that the liability of the reinsurers is limited to the sum in respect of which Charter Re insurance has discharged its liabilities in respect of the risks which it insured. Mr. Sumption Q.C. says that this is the natural meaning of the words. There is nothing in the context which requires them to be given a different meaning and that is the end of the matter.

I think that in some cases the notion of words having a natural meaning is not a very helpful one. Because the meaning of words is so sensitive to syntax and context, the natural meaning of words in one sentence may be

quite unnatural in another. Thus a statement that words have a particular natural meaning may mean no more than that in many contexts they will have that meaning. In other contexts their meaning will be different but no less natural.

Take, for example, the word "pay". In many contexts, it will mean that money has changed hands, usually in discharge of some liability. In other contexts, it will mean only that a liability was incurred, without necessarily having been discharged. A wife comes home with a new dress and her husband says "What did you pay for it?" She would not be understanding his question in its natural meaning if she answered "Nothing, because the shop gave me 30 days credit". It is perfectly clear from the context that the husband wanted to know the amount of the liability which she incurred, whether or not that liability has been discharged.

What is true of ordinary speech is also true of reinsurance. *In re Eddystone Marine Insurance Co., Ex parte Western Insurance Co.* [1892] 2 Ch. 423 the policy contained the form of reinsurance clause then in common use "and to pay as may be paid thereon." As in this case, the reinsured company was in insolvent winding up and could not pay its debts. Stirling J. said, at p. 427, that the policy did not mean that the liability should have been discharged. They meant only that "the payment to be made on the reinsurance policy is to be regulated by that to be made on the original policy of insurance." In other words, the clause is concerned with the amount of liability and is indifferent to whether or not it has been discharged.

But, said Mr. Sumption, there is the word "actually". Stirling J. might have been willing to accept that paid could in some artificial or figurative sense mean "liable to be paid." But the word "actually" was surely added to make it clear that money must have changed hands. "Actually paid" said Mr. Sumption, meant actually paid.

One speaks of something being "actually" the case to point a contrast: perhaps with what appears to be the case, or with what might be the case, or with what is deemed to be the case. The effect of the word therefore depends upon the nature of the distinction which the speaker is wanting to make. This can appear only from the context in which the phrase is used. It is artificial to start with some contextual preconception about the meaning of the words and then see whether that meaning is somehow displaced. The context might indicate that the word was used to reverse the ruling in the *Eddystone* case and require the liability of the reinsured to have been discharged. On the other hand, it might suggest that a different contrast was intended.

To revert to my domestic example, if the wife had answered "Well, the dress was marked £300, but they were having a sale" and the husband then asked "So what did you actually pay?", she would again be giving the question an unnatural meaning if she answered "I have not paid anything yet". It is obvious that the contrast which the husband wishes to draw is between

the price as marked and the lower price which was charged. He is still not concerned with whether the liability has been discharged. This is not a loose use of language. In the context of the rest of the conversation, it is the natural meaning.

What then is the context? Is the draftsman wanting to draw a contrast with the meaning given to "paid" in the *Eddystone* case [1893] 2 Ch. 423 or does he have some other contrast in mind? My noble and learned friend Lord Mustill has analysed the structure of the policies and for the reasons which he gives, I agree that the context points to a wish to emphasise the net character of the liability as opposed to what, under the terms of the policies, the liability might have been.

I think that these conclusions are reinforced by the history of reinsurance clauses. Contracts of reinsurance were unlawful until 1864. Such a contract is not an insurance of the primary insurer's potential liability or disbursement. It is an independent contract between reinsured and reinsurer in which the subject-matter of the insurance is the same as that of the primary insurance, that is to say, the risk to the ship or goods or whatever might be insured. The difference lies in the nature of the insurable interest, which in the case of the primary insurer, arises from his liability under the original policy: see Buckley L.J. in *British Dominions General Insurance Co. Ltd. v. Duder* [1915] 2 K.B. 394, 400.

The difference in the nature of the insurable interest does however mean that, insurance being a contract of indemnity, the amount recoverable will not necessarily be the same as under the primary insurance. For example, the liability of the primary insurer will not necessarily be for the whole loss suffered by the original insured but may be subject to exceptions and limitations. His net outlay can also be reduced by recoveries under his right of subrogation. It therefore became customary in the market to have a special clause or clauses which defined the extent of the reinsurer's liability. It appears that the most commonly used form in the early years of reinsurance was to add the words "Being a reinsurance, subject to all clauses and conditions of the original policy, and to pay as may be paid thereon." (see *McArthur, The Contract of Marine Insurance* 2nd ed., (1890), p. 332 and the form of policy in *Uzielli v. The Boston Marine Insurance Co. Ltd.* (1884) 15 Q.B.D. 11, 12.)

As construed by the courts, however, the phrase "and to pay as may be paid thereon" disappointed the expectations of the market on both sides. The original insurers assumed that it meant that if they agreed in good faith to pay under the original policy, they would be able to recover without having to prove their own legal liability. Reinsurers assumed that whatever the loss of the original insured might be, their liability would not exceed the nett outlay of the reinsured, after taking all recoveries into account. Both assumptions were to prove false.

The story of how the expectations of original insurers were disappointed by the decision of Mathew J. in *Chippendale v. Holt* (1895) 1 Com. Cas. 197 and the subsequent development of the "follow settlements" clause to restore what had been thought to be the effect of the old clause has been told more than once, including by Scrutton L.J., who was junior counsel in *Chippendale v. Holt*, in *Gurney v. Grimmer* (1932) 44 Lloyd's L.R. 189. 192-194. (For subsequent developments, see Robert Goff L.J. in *Insurance Co. of Africa v. Scor (UK) Reinsurance Co. Ltd.* [1985] 1 Lloyd's Rep. 312.)

The second assumption, on the part of reinsurers, had however been shaken by an even earlier decision. In *Uzielli v. The Boston Marine Insurance Co. Ltd.* (1884) 15 Q.B.D. 11 the defendants were reinsurers of the reinsurers of the *Rose Middleton*, which had been insured in the sum of £1,000. The ship went aground and the owners gave notice of abandonment to the original underwriters. The underwriters disputed the validity of the notice but eventually settled the claim for 88 per cent. But they also spent more money in getting the ship off the rocks than they eventually realised in selling her. The result was that they incurred a total loss of 112 per cent. They recovered the additional sum from the plaintiffs, their reinsurers, under a "sue and labour" clause in the policy which entitled them to recover such expenditure reasonably incurred by the insurers or their "factors or servants or assigns". The plaintiffs in turn claimed £1,120 from the defendants. Matthew J. held that there had been a constructive total loss, that the reinsurers were entitled to add the expenditure of the underwriters on salvage under the "sue and labour" clause and gave judgment for £1,120. The reinsurers appealed and the Court of Appeal held that, as against the defendants, the "sue and labour" clause did not cover expenditure by the original underwriters because they were not the "factors or servants or assigns" of the first reinsurers. One might have thought that the result would be that the plaintiffs could recover only the 88% of the £1,000 for which the claim of the shipowner had been settled. That was what had been paid on the original insurance policy. Instead, however, the court substituted a judgment in favour of the underwriters for £1,000.

The *Uzielli* case caused a good deal of puzzlement in the market and among marine insurance lawyers. Mr. McArthur (*The Contract of Marine Insurance*, 2nd ed., p. 335) said that "as the facts in the case were peculiar, no general principle can be deduced from the decision" (op. cit., p. 335). In *Western Assurance Co. of Toronto v. Poole* [1903] 1 K.B. 376, 387-388, Mr. Hamilton Q.C. and Mr. Scrutton Q.C. offered Bigham J. different explanations of the case, neither of which he found satisfactory. In *British Dominions General Insurance Co. v. Duder* [1915] 2 K.B. 394, Buckley L.J. said that he could not find any principle in the case (p. 402). Pickford L.J. likewise said that it was very hard to understand (p. 405) and Bankes L.J. was similarly perplexed: see p. 413. Although the principle of indemnity is fully reaffirmed in *Duder* it would not be surprising if the market felt nervous that

the House of Lords might one day see some light in *Uzielli* which had eluded other judges since the time it was decided.

Although the commercial history of the matter is not as well documented as that of the "follow settlements" clause, it is clear that the formula "pay as may be paid thereon" disappeared from standard forms of reinsurance. The objects which it had sought to achieve on behalf of the original insurers were taken over by the follow settlements clause. It does not seem unreasonable to infer that its function in delimiting the liability of the reinsurers was taken over by the ultimate net loss clause. The UNL clause shows throughout a preoccupation with ensuring that the reinsurer cannot be called upon to pay more than the reinsured has been required to pay. In *Uzielli* the words "pay as may be paid" had proved ineffective to achieve this result, even though they had been thought apt to do so. In his argument in *Duder* ([1915] 2 K.B. 349, 398) Mr. Doehle Q.C., arguing for a similar result to that in *Uzielli*, said plaintively but truthfully, that the words "pay as may be paid thereon":

"...weakened the case of the plaintiffs, and yet this Court held that they could recover the full 100 per cent and not merely the 88 per cent for which they had settled the claim against them."

It would not therefore be surprising if underwriters thought that if "paid" was not good enough to satisfy the courts, "actually paid" might drive the point home.

The UNL clause in the policies before the House has been traced back in unaltered form to the early 1930's and I would not be surprised if it went even further back than that. The words "actually paid" can be found in the policy considered in *Allemannia Insurance Co. of Pittsburg v. Firemen's Insurance Co. of Baltimore* 209 U.S. 326, where they were given the construction which I suggest in this case.

I find further support for my view in the fact that the UNL clause has been thought suitable for use in the London excess of loss reinsurance market. There are certainly forms of reinsurance in which it may be commercially appropriate to make discharge of his liability by the reinsured a condition of the liability of the reinsurer. It may be, as in cases of mutual insurance, that the reinsurer has an interest in making certain that the reinsured maintains sufficient liquid assets to meet his liabilities. Or it may be a protection against fraudulent claims. But the London excess of loss market operates on the assumption that a reinsurance programme will relieve the insurer of the burden of having to pay claims covered by the reinsured layers. The regulation of insurers in this country uses a test of solvency which treats reinsurance cover as a proper deduction from the insurer's liabilities. None of this would make sense if the insurer had first to satisfy the claim out of his own resources before he could call upon his reinsurers to pay.

Mr. Sumption suggested a stratagem which insurers might use to avoid having to pay the whole claim themselves. They could pay a part, even a very small part, of the reinsured liability and then, having to this extent actually paid, they could call upon the reinsurer to reimburse them. Having thus primed the pump, they could by successive strokes draw up the full amount from the reinsurance well. I cannot imagine that the parties could ever have contemplated such a strange procedure and one is bound to ask what commercial purpose the reinsurer could have expected to achieve by being able to insist upon it.

Considerations of history, language and commercial background therefore lead me to the conclusion that the word "actually" in the UNL clause is used to emphasise that the loss for which the reinsurer is to be liable is to be net and that the clause does not restrict liability to the amount by which the liability of the reinsured for the loss has been discharged. I think that this is the natural meaning of the clause.

In conclusion I would like to pay tribute to the judgment of Mance J. which deals comprehensively with the issues and all the relevant authorities and with which I am in full agreement. I would dismiss the appeal.

Constitution:

Lord Justice Nourse
Lord Justice Staughton
Lord Justice Simon Brown

Charter Reinsurance Company Limited

-v-

Fagan

Staughton LJ:

The appeal of Mr Fagan and his names (whom I shall call the Reinsurers) raises issues of general interest for the insurance market and in the law of contract generally. To what extent should one depart from the plain meaning of the words in a contract in order to avoid a result which is unreasonable, or even absurd? Who is to be the judge of reasonableness? And on what material is it to be decided? These issues are also of some difficulty. One of them involves a choice between conflicting decisions of the United States Supreme Court.

Charter Reinsurance Co. Ltd (the Insurers) are now in provisional liquidation. They formerly carried on the business of insurance and reinsurance. In the course of it they concluded three contracts of reinsurance with the Reinsurers:

- (1) on their 1989 whole account, for £2 million in excess of £3 million each and every loss and/or catastrophe and/or calamity and/or occurrence and/or series of occurrences arising out of one event;
- (2) on the same risk, for £2.5 million in excess of £7.5

million;

- (3) on aviation risks, for £2.5 million in excess of £28 million each and every loss (as defined).

There were also limits in US and Canadian dollars, which I need not mention. In each of the contracts there was a clause saying that it covered "losses occurring" during a period, that is to say the calendar year 1989 for the two whole account contracts and the calendar year 1990 for the aviation contract.

Losses have arisen on business underwritten by the Insurers. In particular, the losses with the names of Exxon Valdez, Phillips Petroleum and Australian Earthquakes attach to the Insurers' whole account; and India Airlines and CAAC Airways attach to their aviation account. We are asked to assume that claims have been presented to the Insurers in respect of those losses, that they have agreed their liability in respect of those claims, but by reason of inability to pay debts as and when they fall due they are at present not able to pay those claims.

In case it be thought that misfortune has fallen only upon the Insurers, I would add that Mr Fagan's two syndicates ceased underwriting in 1990 and are now under run-off management.

The question is whether the Reinsurers are liable to indemnify the Insurers in respect of sums which the Insurers have not yet paid, either by a transfer of funds or by a settlement in account, although the amount of the loss has been agreed. In an agreed statement of facts there is this cri de coeur:

Both [the Insurers and the Reinsurers] recognize that the "actually paid" issue is a London market-wide problem. The three contracts at issue in these proceedings are but examples of one type of excess of loss reinsurance contract wording in wide usage in the

reinsurance market. Both parties wish this issue to be determined for the benefit of the reinsurance market as a whole.

Mance J. decided the question in favour of the Insurers; and the Reinsurers now appeal. I should say at once that the argument on the appeal has evidently been more closely confined than it was before the judge.

The Terms of the Contracts

The two whole-account contracts contained the same clauses that are material:

REINSURING CLAUSE

This Reinsurance is to pay all losses howsoever and wheresoever arising during the period of this Reinsurance on any Interest under Policies and/or Contracts of Insurance and/or Reinsurance underwritten by the Reinsured in their Whole Account.
Subject however to the following terms and conditions.

LIABILITY CLAUSE

The Reinsurers shall only be liable if and when the Ultimate Nett Loss sustained by the Reinsured in respect of interest coming within the scope of the Reinsuring Clause exceeds £3,000,000 or U.S. or Can. \$6,000,000 each and every loss and/or Catastrophe and/or Calamity and/or Occurrence and/or Series of Occurrences arising out of one event and the Reinsurers shall thereupon become liable for the amount in excess thereof in each and every loss, but their liability hereunder is limited to £2,000,000 or U.S. or Can. \$4,000,000 each and every loss and/or Catastrophe and/or Calamity and/or Occurrence and/or Series of Occurrences arising out of one event.

ULTIMATE NETT LOSS CLAUSE

The term "Nett Loss" shall mean the sum actually paid by the Reinsured in settlement of losses or liability after making deductions for all recoveries, all salvages and all claims upon other Reinsurances whether collected or not and shall include all adjustment expenses arising from the

settlement of claims other than the salaries of employees and the office expenses of the Reinsured.

All Salvages, Recoveries or Payments recovered or received subsequent to a loss settlement under this Reinsurance shall be applied as if recovered or received prior to the aforesaid settlement and all necessary adjustments shall be made by the parties hereto. Provided always that nothing in this clause shall be construed to mean that losses under this Reinsurance are not recoverable until the Reinsured's Ultimate Nett Loss has been ascertained.

CURRENCY CLAUSE

Losses (if any) paid by the Reinsured in currencies other than Sterling, shall be converted into Sterling at the rate of exchange ruling at the date of the settlement of loss or losses by the Reinsured other than losses paid in U.S. or Can. Dollars which will be paid in those currencies.

CLAIMS CLAUSE

In the event of loss which may cause a claim under this Policy, the Reinsured shall give immediate notice to the Reinsurers, but inadvertent error or omission of such notification shall not prejudice this Policy. All loss settlements by the Reinsured shall be binding upon the Reinsurers provided that such settlements are within the terms and conditions of the Original Policies and within the terms and conditions of this policy and the Reinsurers shall pay the amounts due from them upon reasonable evidence of the amounts paid being given by the Reinsured.

The third contract, relating to aviation risks, was in somewhat different terms, so far as material:

ARTICLE 7 - REINSURING CLAUSE

This Reinsurance is to Indemnify the Reinsured, subject to its provisions, for all losses which may be sustained by the Reinsured in excess of an Ultimate Nett Loss of £28,000,000 or U.S. or Can. \$56,000,000 or equivalent in other currencies each and every loss, as defined herein, up to a further £2,500,000 or U.S. or Can. \$5,000,000 each and every such loss.

Notwithstanding the foregoing Reinsurers shall also be liable for any amount up to the sum reinsured hereunder by which the Reinsured's Ultimate Nett Loss exceeds £6,000,000/\$12,000,000 each and every loss etc. as defined

after all possible recoveries have been made under the Reinsured's underlying Excess Loss Programmes as Schedule.

ARTICLE 8 - ORIGINAL AVIATION LOSS WARRANTY CLAUSE

This Reinsurance shall only apply to a claim (or claims) where the "Total Original Incurred Aviation Loss" (or Losses) is equal to or exceeds US\$50,000,000 or the equivalent in any other currency based upon the reserve in the London Aviation Market, as defined hereunder, at the time of the claim hereunder.

Nothing in this clause shall mean that loss (or losses) are not recoverable hereon until the "Total Original Incurred Aviation Loss" has been finally determined and paid. The Reinsured specifically agrees to return all claims monies received from Reinsurers hereon as soon as practicable, in respect of any loss (or losses) which (a) is finally determined at below US\$50,000,000 or equivalent in any other currency or (b) when the reserve, as defined hereunder, is reduced to below US\$50,000,000 or equivalent in any other currency, whichever the sooner.

The terms "Total Original Incurred Aviation Loss" shall mean the insured loss of the Hull (or Hulls) involved in the loss (or losses), whether insured in the Aviation Market or otherwise, before the deduction of any excess or co-insurance retained by the Original Insured, if any, plus the total of all liabilities to passengers and third parties (excluding Personal Accident Insurance and Workmans Compensation Act payments) whether the amounts have been paid or promised to be paid or reserved whilst under negotiation or dispute with the original Claimant(s). Such amounts being determined by the Leading London Aviation Market Slip Insurers or Reinsurers in conjunction with their Adjusters, Attorneys or Solicitors and shall be inclusive of all loss costs and expenses of adjustment, defence or representation directly or indirectly attributable to the Original Loss (or Losses) coming within the definition of loss hereunder. In the event of no London Aviation market reserve, the reserve for the purposes of this clause shall be that amount as advised to the Original Underwriters as an estimate of their liability by their Adjusters, Attorneys or Solicitors.

Notwithstanding anything contained herein to the contrary all loss reserves, as defined above, are to be agreed by the Leading Underwriter hereon.

This clause shall be subject to the general terms, limits and conditions of this Reinsurance and the foregoing provisions shall take precedence in the event of any inconsistency.

ARTICLE 9 - DEFINITION OF LOSS CLAUSE

For the purposes of this Reinsurance the term 'each and every loss' shall be understood to mean loss and/or accident and/or occurrence and/or catastrophe and/or calamity and/or series thereof arising out of one event.

ARTICLE 10 - ULTIMATE NETT LOSS CLAUSE

The term "Ultimate Nett Loss" shall mean the sum actually paid by the Reinsured in settlement of losses or liability after making deductions for all recoveries, all salvages and all claims upon other Reinsurances whether collected or not and shall include all adjustment expenses arising from the settlement of claims other than the salaries of employees and the office expenses of the Reinsured.

All Salvages, Recoveries and Payments recovered or received subsequent to a loss settlement under this Reinsurance shall be regarded as if recovered or received prior to the said settlement and all necessary adjustments shall be undertaken by the parties hereto.

Nothing, however, in this clause shall be construed to mean that losses are not recoverable from Reinsurers until the Ultimate Nett Loss to the Reinsured has been determined.

ARTICLE 15 - CURRENCY CONVERSION CLAUSE

For the purpose of this Reinsurance all claims paid by the Reinsured in currencies other than Sterling, United States Dollars or Canadian Dollars shall be converted into Sterling at the rate of exchange at which such items are entered in the Reinsured's books.

ARTICLE 18 - REINSURANCE CLAUSE

This Reinsurance shall be deemed to be subject to the same terms, clauses and conditions as the Original Policies as far as they may be applicable hereto, and shall pay as may be paid thereon, but subject nevertheless to the terms and conditions of this Reinsurance.

ARTICLE 22 - SPECIAL CANCELLATION CLAUSES

Either party shall have the right to terminate this Reinsurance immediately by giving the other party notice by Telex or Telegram and shall be deemed to be served upon despatch or where communications between the parties are interrupted upon attempted despatch.

- (i) If the performance of the whole or any part of this Reinsurance be prohibited or rendered impossible de jure or de facto in particular and without prejudice to the generality of the preceding words in consequence of any law or regulation which is or shall be in force in any country or territory or if any law or regulation shall prevent directly or indirectly the remittance of any payments due to or from either party.
- (ii) If the other party has become insolvent or unable to pay its debts or has lost the whole or any part of its paid up capital.
- (iii) If there is any material change in the management or control of the other party.
- (iv) If the country or territory in which the other party resides or has its head office or is incorporated shall be involved in armed hostilities with any other country whether war be declared or not or is partly or wholly occupied by another power or be in a state of civil war.
- (v) If the other party shall have failed to comply with any of the terms and conditions of this Reinsurance.

All notices of termination served in accordance with any of the provisions of this Article shall be addressed to the party concerned at its head office or at any other address previously designated by the party.

The REINSURER shall remain liable for losses occurring up to and including the date of termination. Thereafter the liability of the REINSURERS shall cease outright other than so far as outstanding claims are concerned.

In the event of this Reinsurance being terminated in accordance with the provisions of this Article the exact premium payable hereunder shall be based on the premium income figure for the period from inception to the effective date of termination and shall be subject to a minimum premium calculated on the amount specified in Article 17 pro rata for the effective period.

Approach to interpretation of the contracts

Like the judge I take this topic first. It is now well settled that no contract is to be construed in a vacuum. Although we may start with the literal meaning of the words, they should not be considered in isolation, but rather in the light

of the surrounding circumstances (or, if one prefers it, the background, context or matrix) when the contract was made. That process may even, on occasion, lead one to reject the literal meaning of the words and to adopt some other interpretation.

So too it may be appropriate to consider whether the literal meaning of the words leads to a result that is unreasonable or even absurd. The classic exposition of that doctrine is, in my opinion, to be found in the speech of Lord Reid in L. Schuler AG v. Wickman Machine Tool Sales Ltd (1974) AC 235 at p. 251:

The fact that a particular construction leads to a very unreasonable result must be a relevant consideration. The more unreasonable the result the more unlikely it is that the parties can have intended it, and if they do intend it the more necessary it is that they shall make that intention abundantly clear.

That short passage comprehends almost everything that needs to be said on this topic. It shows (1) that there is in general, and apart from consumer protection legislation, no law against people making unreasonable contracts if they wish; (2) whether they have done so is to be decided by ascertaining their intention (which of course has to be found in the language they used read in the light of the surrounding circumstances); and (3) it is a matter of degree in two respects - the more unreasonable the result, the clearer the language needed.

We are also to have regard to the object, purpose, genesis or aim of the transaction, viewed objectively and ascertained from the factual background: Utica City National Bank v. Gunn (1918) 118 NE 607 at p. 608 (Cardozo J.), Prenn v. Simmonds (1971) 1 WLR 1381 at p. 1385 (Lord Wilberforce), Reardon Smith Line Ltd v. Hansen-Tangen (1976) 1 WLR 989 at p. 995 (Lord

Wilberforce), Lord Diplock deprecated the use of the word "purposive" in connection with the interpretation of private contracts as opposed to statutes (Antaios Compania Naviera SA v. Salen Rederiana SA (1985) AC 191 at p.200). Parker LJ in Home & Overseas Insurance Co. Ltd. v. Mentor Insurance Co. (UK) Ltd (1989) 1 Ll. R. 473 at p. 486 questioned what Lord Diplock's objection was. For my part, however, I can see that interpreting the language of Parliament in order to achieve its manifest objective is a somewhat different process from the interpretation of a private contract. That view is, I think, supported by a passage from the Palm Shipping Case quoted below.

It is not difficult to find instances where the literal meaning of words has been modified or even rejected, by reason of the surrounding circumstances, or the absurdity of the results which would otherwise ensue, or both considerations. Thus in Schuler v. Wickman itself it was held that the words

it shall be a condition of this agreement
did not mean what lawyers would ordinarily understand by a condition. By contrast in the Antaios case it was held that the words

on any breach of this charterparty
did not mean any breach, but any repudiatory breach. A good example is to be found in Segovia Compania Naviera SA v. R. Pagnan & Fratelli (1977) 1 Ll. R. 343. There a charterparty provided that the charterers might order the vessel

to any United States port East of Panama Canal.
It so happens that all ports in the US Gulf and most or all of those in Florida are West of the Panama Canal. Nevertheless they

were held to be within the charterers' range of choice.

A recent example quoted by Mance J. is Arbuthnott v. Fagan (30th July 1993, Lexis). A claim against agents for negligent underwriting was held not to arise out of or be in any way connected with the agents' requirement to be put in funds to meet insurance claims.

Mance J. thought that considerations of reasonableness were of particular relevance in a commercial context; but I am not sure that I would agree with him on that. A contract between a house-owner and his builder or decorator is just as much to be construed in accordance with Lord Reid's formula as one between mercantile concerns operating on a shipping or commodity exchange. One often reads in the cases of commercial common sense, or business common sense; but that is not some arcane substance of a special and unusual nature. It is common sense or reasonableness in the context of the business in question.

So in this case we must first consider what the contracts say on the literal meaning of their wording, and how clearly they say it; and then whether that meaning would be unreasonable, and if so how unreasonable. (I do not of course exclude surrounding circumstances.) For the proposition that it is legitimate to start with the literal meaning I can, as the judge did, refer to what Saville J. said, quoting Lord Goff of Chieveley, in Palm Shipping Inc. v. Kuwait Petroleum Corporation (1988) 1 Ll. R. 500 at p. 502:

The starting point must be the words and phrases the parties have chosen to use. It is not a permissible method of construction to propound a general or generally accepted principle for sharing the risk of delay between owners and charterers or seeking in the

abstract to determine a reasonable allocation of risk of delay and then (to use the words of Lord Goff in The Notos [1987] 1 Lloyd's Rep. 503 at p. 506) to seek to force the provisions of the charter into the straitjacket of that principle or into that concept of reasonableness. To do so is to rewrite the bargain that the parties must be taken to have made by the words that they have chosen to use.

The language used in the contracts

The whole account contracts are in somewhat different terms from the aviation contract. Yet I doubt if the insurance industry will be altogether pleased if we hold that this leads to different results. So are we to reach an interpretation on one of them first, and then hold that it must apply to the others? And if so, which should we begin with? This illustrates a perennial problem in the interpretations of contracts commonly used in a particular branch of commerce: one is referred to decisions on other wording which is different but not very different, and then asked to proceed from that to the contract in question. Yet if there is a difference, it may be critical. I cannot escape the conclusion that in this case we must give independent consideration to the different forms of contract.

(a) The whole account contract

The Liability Clause seems to me as clear as can be. It says that the Reinsurers shall ONLY be liable IF AND WHEN the ultimate net loss exceeds £3 million in one case, and £7.5 million in the other. It follows as the night the day that until that event happens the Reinsurers are NOT liable.

One then turns to the Ultimate Net Loss Clause. At first there is a slight problem - it refers to

"The term 'Net Loss'."

Those words are not used elsewhere on their own. However, I can see why it was thought necessary to define them. The Net Loss is to be the amount paid by the Insurers plus expenses but less recoveries. Then it is said in the second sentence that recoveries made (sc. by the Insurers) after the Reinsurers have paid shall, in effect, go to the credit of the Reinsurers. That necessarily entails that the Reinsurers may have been called upon to pay before recoveries are received. That implication is confirmed in the third sentence or proviso. So the Insurers must be entitled to payment as soon as the net loss exceeds the lower limit in the contract, even if the final net loss remains to be ascertained.

The remaining problem is that this interpretation gives a different meaning to Ultimate Net Loss in the Liability Clause and Ultimate Net Loss in the proviso or third sentence of the Ultimate Net Loss Clause. In the earlier place it means the net loss as existing at any given moment; in the later, the net loss when all has been resolved. I would be shocked by such inconsistency in a document drafted in Chancery; but I am not sure that we are entitled to expect such a high standard in an insurance contract. And as it happens we do know that the proviso was drafted by a different hand, or at any rate at a different time, from the rest of the clause. (cf. the "collage of clauses" in Bremer Handelsgesellschaft mbH v. Vanden Avenne-Izegem PVBA (1978) 2 Ll.R. 109 at p.113).

Once that point is resolved, the combined effect of the Liability Clause and the Ultimate Net Loss Clause is to my mind

perfectly clear: the Reinsurers are to be liable only for sums actually paid by the Insurers. The word actually means, in that context, in fact or in reality. It must have been added so that there could be no argument about sums which were payable, or deemed to be paid, or liable to be paid.

Mr Kentridge for the Insurers argues that the Ultimate Net Loss Clause is concerned with amount, and with ensuring that the Reinsurers do not, for example, pay 100 per cent of a claim when the Insurers have settled it for 60 per cent. I would agree that one of the matters that it deals with is amount. But the second sentence and the proviso are clearly concerned with timing; and so, beyond all doubt, is the Liability Clause.

In those circumstances it is unnecessary to consider whether the Currency Clause and the Claims Clause add further support to the conclusion that the Reinsurers are only liable for sums that have been paid. But in my opinion the Claims Clause does to a significant extent, since it requires "reasonable evidence of the amounts paid".

(b) The aviation contract

There are a number of points to note:

- (i) The reinsurance is to "indemnify the Reinsured ... for all losses sustained."
- (ii) But they must be "in excess of an Ultimate Net Loss of £28,000,000".
- (iii) The Original Aviation Loss Warranty Clause is somewhat obscure to an untutored eye. But it does not seem to me to bear on the present problem.
- (iv) The Ultimate Net Loss Clause is for practical purposes the same as that in the two whole account contracts. It presents the same problem that the words "ultimate net loss" refer in one place to the final figure but must in the Reinsuring Clause include an interim figure. Apart from that the wording is plain; once

more there is express reference to "the sum actually paid".

- (v) The aviation contract does not have the requirement in the whole account contracts that "reasonable evidence of the amounts paid" should be given by the Insurers. Instead the Reinsurance Clause says that the reinsurance "shall pay as may be paid" by the Insurers. That phrase has been held not to impose a requirement that the Insurers shall have paid before the Reinsurers are liable.
- (vi) The Special Cancellation Clauses give either party the right to terminate upon a number of events, of which one is the insolvency of the other party or inability to pay its debts. In the event of termination the Reinsurers "shall remain liable for losses occurring up to and including the date of termination." Mance J. attached importance to this clause; and he described it as "a false friend" in so far as it was relied on by the Reinsurers. However, it is important to identify the "losses", which are referred to in the clause as occurring "up to and including the date of termination". These must in my view be the losses of the original insured persons, which have to occur during the calendar year of the relevant reinsurance contract. (In the whole account contracts there is express reference in the reinsuring clause to "losses howsoever and whensoever arising during the period of this Reinsurance". As Mr Pollock pointed out, if the "losses" there referred to were those of the Insurers when they agreed a claim and became liable to pay it, none of that happened during 1989, and for that reason alone the Reinsurers would be under no liability. The judge was not inclined to accept this argument.) I do not see that the Special Cancellation Clauses are in any way inconsistent with the Reinsurers' interpretation of the aviation contract: they are not to be liable if the original insured's loss, albeit occurring during the calendar year 1990, was after the reinsurance contract had been terminated for any of the reasons set out; but they remain liable in other cases, provided of course that the net loss reaches the minimum payment level to engage the Reinsurers' liability; and they cease to be liable when it exceeds the maximum. Whether the loss has reached the minimum payment level depends upon the words "actually paid." It must in my opinion have been contemplated that termination under Article 22 would take place during the period of reinsurance, and not afterwards: the provision for adjustment of premium shows that. So "losses occurring before termination" will very likely have to be the losses of the original insured rather than of the Insurers.

There was little detailed argument before us by either party aimed at distinguishing the aviation contract from the two whole account contracts. That is understandable. Each sought to succeed on all three contracts. In my opinion the aviation contract, on its literal wording, does provide that the Reinsurers' liability only arises when the Insurers have paid, just as the whole account contracts so provide. But the aviation contract is less clear on that point. If I am asked how much less clear, I can only answer: somewhat less clear. That, as it seems to me, does not necessarily amount to an ambiguity; but I do not think that the presence or absence of an ambiguity is the determinative factor in Lord Reid's test.

Reasonableness or absurdity

Judges in the past have on occasion thought it unreasonable that a reinsurer should not be liable if the primary insurer does not and cannot pay the claim. The case of In re Eddystone Marine Insurance Co. (1892) 2 Ch. 423 was concerned with a reinsurance contract which was "to pay as may be paid" by the primary insurer. Both companies went into liquidation. Stirling J. said (at p.427):

Now, a main object of reinsurance is to relieve the reinsured from a portion of the risk previously undertaken by him; and the result of giving effect to the liquidator's contention would be that, before the reinsured obtains the benefit of his reinsurance, he must himself have paid on the original insurance, even though bankruptcy might be the result.

I think that this could not be intended, and that such a construction ought not to be put on the language of the policy unless it is clearly called for. In my opinion the words do not clearly require to be so construed.

In re Law Guarantee Trust and Accident Society Ltd

(1914) 2 Ch. 617 was concerned with a contract between a guarantee society (which later went into liquidation) and a mortgage insurance company. The contract in question provided (p.620)

The Liverpool Mortgage Insurance Company, Limited ... hereby guarantee the within named Law Guarantee and Trust Society, Limited ... to the extent of 5000l. being two-elevenths of the risk assured by, and subject to, the conditions of the within policy of debenture insurance, and also the like proportion of all costs and expenses incurred by the society ...

Buckley and Kennedy LJJ and Scrutton J. all referred to the Eddystone case with approval. As to reasonableness or the lack of it, Buckley LJ said this (at p.634):

I am anxious to point out some consequences which would ensue if the view I have expressed were not the right one. The contrary view is one which makes it to the interest of the company that the society should be insolvent. For to such extent as the society cannot pay in full the argument is that the company are not liable to make payment. It is obvious that such a consideration cannot have entered into the contemplation of the parties in fixing the premium. The company has received a certain premium upon the terms that in an event it shall pay a certain sum. If its liability is reduced to 10s. in the pound, it has received payment of premium as the price of an obligation to pay 20s., but is, by reason of circumstances not material at all so far as the company is concerned, relieved of one half of the liability. If this were true a society whose credit was bad ought to pay a less premium than a society whose credit was good, because the obligation would in the former case result in a smaller liability. The fact is, I suppose, that as a matter of business if the credit of the society were bad a larger, not a less, premium would be demanded as the price of the guarantee.

It is to be observed that both the Eddystone case and the Law Guarantee case were concerned with reinsurance against a

share of the original loss, where as here we are concerned with reinsurance of the excess above a given figure. That might well make a difference on a question of interpretation of the contracts. But it is not a relevant distinction on the question presently under consideration, unreasonableness or absurdity.

The Eddystone case was again cited in British Dominions General Insurance Co. Ltd v. Duder (1915) 2 KB 394 and Versicherungs und Transport AG Daugava v. Henderson (1934) 49 Ll. R. 252. But I can find no assistance in those cases as to what is or is not unreasonable. In the latter case Scrutton LJ began his judgment (at p.353):

This appeal raises a very short point of construction on very short agreed facts, and has been dealt with by Mr Justice Roche in a very short judgment.

The case of The FANTI and the PADRE ISLAND (1990) 2 Ll. R. 191 sheds a different light on reasonableness. It was concerned with the liability of mutual protection and indemnity associations, which afford cover to their members against liabilities and expenses under various heads in the business of shipowning. The relevant contractual provision for the FANTI was this:

4. ... the Member shall be protected and indemnified against all or any of the following claims and expenses which he shall have become liable to pay and shall in fact have paid. ... (q) for loss or damage caused to ... property ... carried on board a ship entered in this class ...

The wording of another protection and indemnity association, in which the PADRE ISLAND was entered, was not materially different.

There is little discussion in the speeches of the House of

Lords as to whether the rules in question were or were not unreasonable, since the wording was clear. Lord Goff of Chieveley said (at p.202):

If the condition is in sufficiently clear terms, it would be contrary to principle that equity should grant specific performance of the contract inconsistently with the terms of the contract. In the present cases, the condition of prior payment is perfectly clear. The clubs are only bound to indemnify a member against claims or expenses which he shall become liable to pay and shall in fact have paid. The reason why this provision was included in the rules seems to me to be immaterial. I should record that Mr Boyd, for the West of England Club, put forward a rather different reason for its inclusion from that proposed by Mr Sumption. He suggested that, in a mutual insurance association such as a P. & I. club, it is essential that members should be able to assume the financial probity of other members, because all of them are insurers as well as insured. To that end, it is customary to require each member to discharge his own liability before he can be indemnified against it by the club. Each member is, after all, running his own business: it is up to him to make sure that a claim against him is well founded, and the best way of ensuring that is to require him first to pay the claim before seeking indemnity from the club. I must confess that I was much attracted by this submission. Your Lordships do not however have to choose between Mr Sumption and Mr Boyd's submissions on this point, especially as it is not inconceivable that they are both correct. For the fact remains that the rules provide unambiguously that there is no present obligation on the club to indemnify the member unless the condition of prior payment has been fulfilled; and for equity to grant specific performance of the contract, inconsistently with that condition, would, as I have said, be contrary to principle.

The reason proposed by Mr Sumption was, I think,

to prevent a member from making a profit from his insurance cover by receiving payment from the club but failing to pay the third party (p.200).

What I find of some significance for present purposes is that shipowners had for a great many years been content to

contract with protection and indemnity associations on terms that they could only recover what they "shall in fact have paid". Can one nevertheless say that such a contract is unreasonable, uncommercial or absurd? The argument gains further modest support if one turns to the rules of the Sunderland Steamship Protection and Indemnity Association, cited in my judgment at first instance in the FANTI case (1987) 2 Ll. R. 299 at p.303:

... Provided always that in the case of a liability actual payment (which shall be made out of monies belonging to him absolutely and not by way of loan or otherwise) by the Member or other insured persons of the full amount of such liability shall, unless the Directors otherwise decide, be a condition precedent to the right of the Member or other insured person to recover and the obligation of the Association to satisfy and make good.

Presumably the members of the Sunderland Association were content with that rule.

I now turn to the substantive arguments on unreasonableness as they were put before us.

There was no direct evidence that on the Reinsurers' construction the contracts were unreasonable. Whether such evidence would be admissible or not - we must bear well in mind that the undue proliferation of expert evidence is a major cause of the present high cost of litigation - I very much doubt whether it would be helpful. Witnesses can explain the background, context, surrounding circumstances or matrix. As we have no such evidence, or very little, this is not the case to embark on consideration of what would qualify under that head. Surrounding circumstances must at least be known, or capable of being known, to both parties at the time when the contract is

made. (Reardon Smith Line v. Hansen-Tangen by Lord Wilberforce at p.996) Perhaps they might include the general nature of the risks which Charter Reinsurance would insure, the circumstances and manner in which claims were liable to arise on an excess of loss reinsurance, the proportions in which different kinds of claim occur, the circumstances which Reinsurers take into account in fixing the premiums, and the ostensible solvency of charter Reinsurance. That information might be helpful. But once it is available, two conflicting opinions on whether the contract is unreasonable on one construction are of little value. Even though it be a question of fact, the judge can as well make up his own mind.

The argument for the Insurers emphasized the case where one single claim is made upon them for what is unquestionably one loss, and the claim exceeds the lower limit of the Reinsurers' liability. An example would be a claim for £5 million where the Reinsurers (as here) are liable for £2 million in excess of £3 million. It is said to be unreasonable that the Insurers must first pay £5 million to their insured before they can recover from the Reinsurers.

One answer to that argument is that the Insurers can borrow from their bank. Or if they cannot do that, they need only pay their own share of £3 million and a little bit more, before they start recovering from the Reinsurers; and each recovery can then fund the next payment. This scheme might run into difficulty if the Insurers' financial position was so precarious that a payment by them would be a fraudulent preference. But the main answer to the argument is that the single large claim is not the typical

situation which excess-of-loss reinsurance has to guard against. In support of that we were shown a sheet of figures dated January 1995 stating the ultimate net loss to date for

Exxon Valdez	24.3.89
Phillips Petroleum	23.10.89
Australian Earthquake	28.12.89

That, it was suggested, illustrates how claims arising from a particular casualty accumulate as time goes by, and how from time to time the Insurers would claim upon the excess-of-loss Reinsurers. If a time comes when the Insurers can no longer fund payments to their insured owing to insolvency, it is then that the reinsurance ceases to pay on the Reinsurers' construction. As the parties and the judge recognised, excess of loss reinsurance is often arranged in layers or slices. Those layers will continue to pay in sequence, and so provide funds, for as long as the Insurers can and do pay the claims by their insured. It is only when the Insurers nevertheless become insolvent that the flow ceases.

Buckley LJ in the Law Guarantee case considered it important that the solvency of the primary insurer cannot have been a circumstance that was considered in fixing the premiums. Factually that must be right. But it leads me to ask what circumstances are taken into account in fixing the premium for this type of insurance. We did ask; and despite counsel taking instructions we received no answer. In the first of the whole account contracts, for example, there is a minimum and deposit premium of US \$600,000; and it is to be adjusted so as to equal 1.09 per cent of Insurers' net premium income for the year in question. How was that figure reached, for a reinsurance of £2

million in excess of £3 million? I can only guess that it was based on the underwriter's experience of past claims with these and other primary insurers, and on his judgment of what his rivals would be asking. I do not find much weight in that as an argument that the Reinsurers are - or are not - to pay in full when the Insurers become insolvent.

Mance J. also attached importance to what he described as regulatory and accounting considerations, that is to say (i) the margin of solvency required by Section 32 of the Insurance Companies Act 1982 and the Insurance Companies Regulations 1981, (ii) Section 17 of the Act and the Insurance Companies (Accounts and Statements) Regulations 1983. For my part, I cannot see that these requirements are of any real significance as a guide to the intention of the parties to the contracts which they made in this case. It is no doubt of the highest importance in the national interest that insurance companies should remain solvent; it is no doubt important, to that end, that they have adequate reinsurance on suitable terms. But it is not the task of the courts to interpret private contracts in such a way as to ensure that the national interest is well served. It is for the regulators to carry out their task of regulating, and not for the judges to do so indirectly by the way that they construe contracts.

We have some material on the history of the Ultimate Net Loss clause, and this was considered in the judgment of Mance J. However, neither Mr Kentridge nor Mr Pollock wished to rely on that material in this court; and I too find it of no assistance. In the course of the argument Simon Brown LJ asked if there was

a well recognised clause different from that which we are considering. The answer, according to my note, is that Mr Ruttle, junior counsel for the Reinsurers had seen a contract which said "payable" instead of "paid". That, I am afraid, does not take us very far.

Mr Pollock produced extracts from a booklet published in 1986 by the Reinsurance Offices Association. This was said to be relevant to the question whether the contracts were, on the insurers' construction, unreasonable or absurd, because it was material which the parties would have had in mind. The commentary on the Ultimate Net Loss clause reads in part -

The clause is intended to indicate that the reinsured must indemnify the original insured before it is entitled to claim against the reinsurer However ... the better opinion is that this does not affect the liability of the reinsurers towards the reinsured in the event of a liquidation ... If it is thought necessary a clause to this effect may be added.

The October 1990 version of the booklet, which did not exist when these contracts were made, has this passage:

The clause also provides as do most, although not all such reinsurance covers, that the ultimate net loss consists of losses "actually paid" by the reinsured which is intended to make it clear that the reinsurance is not meant to provide some form of contingency cover but a contract of indemnity against loss.

We were also shown extracts from a booklet of the London Insurance and Reinsurance Market Association, published in June 1992. This reproduces the first of the passages quoted above. It also has this comment upon a Liquidation Clause contained in the booklet:

Although traditional London Market "Ultimate Net Loss" clauses oblige the reinsurer to indemnify the reinsured only in respect of losses which have been "actually paid" by the reinsured, there was always a problem should the reinsured be in liquidation. Under those circumstances the liquidator quite simply could not "actually" pay losses under the reinsured's original policies because he did not have the funds available to enable him to do so.

In the United States this problem has in recent years been surmounted by the inclusion in wordings of a Liquidation Clause which obliges the reinsurer, in the event of the insolvency of the reinsured, to settle losses in full to the liquidator under the original policy.

It is felt that, to make the position absolutely clear in UK wordings, it is advisable likewise to include a Liquidation Clause. This clause, whilst conceding that a contract of reinsurance remains essentially a contract of indemnity, nevertheless obliges the reinsurer in the event of the reinsured's liquidation to pay the liquidator in full even though the liquidator may not already have "actually paid" the loss concerned.

I have grave doubt as to whether the material in any of those booklets is admissible, quite apart from the fact that it was not produced before the judge. But what it does show, to my mind, is that judges should hesitate before coming to an a priori conclusion as to what the object of a particular clause in a contract was, or that its literal meaning would lead to absurdity. The clause in its present form has existed since 1937; the market has apparently realised that there could be some doubt as to its effect when the primary insurer goes into liquidation (and see the American cases cited below); but the parties to these contracts, like many others, made no effort to clarify the position. If one draws any conclusion, it is that they were not much concerned as to whether the Reinsurers would have to pay if the Insurers were in liquidation. If the point

ever arose, which they may have thought very unlikely, then it would be up to the courts to provide a solution.

My conclusions on unreasonableness or absurdity are first, that there is no evidence to support it. Secondly, if the point had expressly been drawn to the parties' attention when the contracts were first made, I am by no means sure that they would have said

Of course we do not mean that.

Rather the Insurers might well acknowledge that if, despite their margin of solvency, there came a time when they were unable to fund payment of claims, then their business would dissolve in ruins whatever these particular Reinsurers did. And the Reinsurers would say that they felt no obligation to contribute to the dividend received by other creditors of the Insurers. True this would leave many unhappy creditors, including those who were insured under the primary cover. But I repeat that it is not for us to regulate for the public good. It is plain, and Mr Kentridge accepts, that the parties are lawfully entitled to make contracts such as Mr Pollock says they did make. They are not obliged to consider the interests of possible future creditors in a possible future liquidation, provided that their present trading does not infringe the insolvency law.

Mr Kentridge suggests that there can be no motive which would influence the Reinsurers to stipulate for payment to cease upon liquidation of the Insurers. I am not sure that he is right; but even if he is, he is answering the wrong question. We should ask whether there is a motive for stipulating that the Insurers must pay before the Reinsurers reimburse them. To that

question there are a number of possible answers: (i) to ensure that the Insurers have satisfied themselves that the claim is well-founded (see Mr Boyd's argument in the Fanti case), (ii) to prevent the Insurers receiving the money themselves and then failing to pay their insured (Mr Sumption, ibid), or (iii) to ensure that if there is delay in the money reaching its ultimate destination, the interest on it accrues to the Reinsurers rather than the Insurers. This last is Mr Pollock's suggestion; most people are familiar with the habit of the insurance industry, or some parts of it, to ask for money promptly when it is due as premium and to pay rather more slowly in response to claims. None of those three reasons is appropriate when the Insurers are in liquidation; but each is a sufficient explanation of why the contract was meant to mean what it says.

Cases directly on the point

The case of Allemannia Fire Insurance Co. v. Fireman's Insurance Co. (1908) 209 US 326 arose out of the great fire in Baltimore in 1904. The clause in a reinsurance contract read:

Losses, if any, shall be payable pro rata with, in the same manner, and upon the same terms and conditions as paid by the said reinsured company under its contracts hereunder reinsured, and in no event shall this company be liable for an amount in excess of a ratable proportion of the sum actually paid to the assured ...

The United States Supreme Court (including Justices Harlan and Holmes) held that the primary insurers were not obliged to pay the loss before enforcing their claim against the reinsurers.

The opposite conclusion was reached by the same court in Fidelity & Deposit Co. v. Pink (1937) 302 US 224. There the

contract provided that the Reinsurer's share of the loss

shall be paid to the Reinsured upon proof of the payment of such items by the Reinsured, and upon delivery to the Reinsurer of all essential documents

...

Again there were distinguished names on the bench. The court said:

Both courts below thought that *Allemannia Insurance Co. v. Fireman's Insurance Co.*, 209 U.S. 326 (1908), [*229] required approval of respondent's contention. This was error. The defense was well taken and should have been sustained.

We do not question the general rules concerning liability of reinsurers announced in the *Allemannia* case; but the liability under any written contract must be determined upon consideration of the words employed, read in the light of attending circumstances.

Here the two insurance companies stood upon an equal footing; both were experts in the field. The language used differs materially from that found in the policy of the *Allemannia* Company. There is no ambiguity and no circumstances requires disregard of the ordinary meaning of the language.

Of English authority the first case that we were referred to was *Gether v. Capper* (1855) 15 CB 697. There the contract was that the owner was to receive

The highest freight which he could prove to have been paid on the same voyage.

It would seem that the owner could prove what had been contracted to be paid, but (not surprisingly) was unable to prove that it had been actually paid. The interlocutory observation of *Jervis* CJ (at p. 701) shows that some members of the court thought proof of the contract sufficient. This was in a wholly different context and is no help at all in the present case.

In the Home & Overseas Insurance case the defendants were insurers who had gone into liquidation and the plaintiffs were reinsurers. The ultimate net loss clause was in the same terms as that which I have quoted (in part) from the two whole account contracts in this case, save that it began

The term "ultimate nett loss"
instead of

The term "Nett Loss".

The reinsurers sought a declaration under O.174 that they were only liable to pay in respect of sums which had been paid by the insurers. The insurers applied for a stay of the action in favour of arbitration.

Hirst J. at first instance dismissed the Order 14 summons and granted a stay. He considered the solution proposed by the reinsurers

both unjust and discordant with commercial good sense
(p.480)

However, he did quote from Butler & Merkin on Reinsurance Law D 2.2-7 including this passage:

... it is of interest to note that, following the *Pink* decision, legislation was enacted in New York - subsequently to be adopted in other states - to ensure that where an original loss has occurred, the reinsurer is liable to pay the full reinsured sum attributable to that loss to the liquidator irrespective of whether or not the ceding company had paid its policy holders. It may well be the case that if reinsurance agreements with English ceding companies were to begin to incorporate clauses which make it clear that the reinsurer's responsibility to pay was limited to sums actually paid, legislation might intervene in a similar way to negative their effect (My emphasis).

"Actually paid" were of course the words used in that case, and

in this case, and presumably in many other contracts at that time.

The Court of Appeal (Parker, Lloyd and Balcombe LJJ) agreed that the appeal should be dismissed, but not because they agreed with the view of Hirst J. as to the meaning of the contract. Parker LJ said this (at p. 484):

I come to the *construction issue*. I fully appreciate the force of Mr Clarke's arguments which received considerable reinforcement from the decisions in another division of this Court ([1989] 1 Lloyd's Rep. 239) in *The Fanti*, [1987] 2 Lloyd's Rep. 299 and *The Padre Island*, [1987] 2 Lloyd's Rep. 529 which were handed down whilst argument on this appeal was in progress. Despite the force of those arguments, however, I have no doubt at all that the question raised is a serious, difficult and important one which deserves mature consideration. Indeed, if it be different, I am satisfied that the plaintiff is on the material before us not entitled to judgment here and now.

So no conclusion was reached, and the dispute went to arbitration. Mr Kentridge relies on the case as showing that there was ambiguity in the ultimate nett loss clause; and he submits that if there is ambiguity the Insurers should succeed. But the same argument would have occurred to the Court of Appeal, and they might in consequence have adopted the view of Hirst J. They did not do so.

Finally there is the decision of the House of Lords in The Fanti case. It had not been argued at first instance, either before Saville J or myself, that the words

and shall in fact have paid

meant anything other than they said. But there was an argument in the Court of Appeal and the House of Lords that equity would

treat them as satisfied if the association's members were merely liable to pay. This was rejected. We have the authority of the House of Lords as to the effect of "those express provisions" (Lord Brandon at p.197) which were "perfectly clear" (Lord Goff at p.202). I can see no relevant distinction between "sum actually paid" and "shall in fact have paid".

It is said that members of a mutual insurance association, sometimes called a "club", are different from those who carry on insurance business and are reinsured. I cannot for my part see that either is likely to be less in business to make profits and avoid losses than the other. But like Lord Goff (if I may say so) I can see some force in Mr Boyd's submission that a P. & I. association is concerned that its members should remain solvent so as to be able to pay supplementary calls if they occur. So too in the present case the deposit premium is provisional, to be adjusted later; and there may be recoveries which the Insurers are obliged to pay over to the Reinsurers. Consequently the Reinsurers have an interest that the Insurers remain solvent. I can see no distinction of any great significance on that ground.

The Respondents' Notice

The first point argued was that it was contrary to public policy for a contract to provide for a result which was repugnant to the insolvency laws; and contracts should be construed so as to avoid that result.

The cases cited in support of that submission were Re Johns (1928) Ch. 737 and British Eagle v. Air France (1975) 1 WLR 758. They are, as it seems to me, concerned with a situation where the

parties by contract seek to provide that one creditor shall, in the event of insolvency, receive more than the appropriate dividend on his debt. They do not touch upon this case, where the contract is concerned with sums payable to the company. A contract may lawfully provide that they shall not be payable in the event of insolvency.

Mr Kentridge mentioned a second argument, based on what was said by Neville J. in Re Law Guarantee Trust and Accident Insurance Corporation Ltd (1915) 1 Ch. 310 at p. 315, that

in law bankruptcy in an action on an indemnity was equivalent to payment.

However, this principle could not be found in the sources to which it was attributed, and Mr Kentridge did not feel able to pursue it.

Conclusion

This dispute is about the meaning of two words, "actually paid". There must come a time when efforts to bend meaning (or, as I would say, reverse it) have to stop. The literal meaning of the words in the contracts requires that the Insurers shall have paid before the Reinsurers are liable. To the extent, if at all, that this produces a result which is unreasonable, it is not so unreasonable that it requires us to depart from the plain meaning of the words. Indeed I doubt whether it is unreasonable at all. Mance J. held that the object of reinsurance is to spread the load. So indeed it is. But it does not follow that any term in a reinsurance contract which results in anything other than an equal division of the loss is to be disregarded. The load is to be spread upon and subject to the terms of the

contract. I would allow this appeal. The judge had been asked by both parties to make a decision under Order 14A; and be granted a declaration that

it is not a condition precedent to the liability of the Defendant to indemnify the Plaintiff ... that the Plaintiff should first have made payment in respect of the ascertained amount of the relevant claim by way of transfer of funds to its insured or have otherwise satisfied the ascertained amount of such claim.

I would delete the word "not", and otherwise grant a declaration in the same terms.

LORD JUSTICE SIMON BROWN: Staughton, L.J.'s judgment helpfully sets out the material relevant to this appeal so that I can express my own contrary opinion altogether more briefly.

The appeal was argued on the basis that it raises a short point of construction - does the phrase in these reinsurance policies "the sum actually paid" mean what it appears to mean or does it mean "the sum actually payable"? In other words, for the reinsurers to be liable, must the reinsured actually have disbursed (or otherwise satisfied) the claim against which the reinsurance is to indemnify them, or it is sufficient that such claim has been established to be immediately payable?

It would not be helpful for me either to cite or seek to rephrase the principles emerging from the many authorities governing the correct approach to construing a commercial contract. Plain it is that the contractual words used may,

whatever their context, be so abundantly clear that however unreasonable the result, they must be given that clear meaning. Failing that, however, then as I understand what Lord Reid said in F.L. Schuler AG v Wickman Tools Machine Sales Ltd (1974) AC 235 at 251, the more unreasonable the result of a given construction, the readier should the court be to adopt some less obvious construction of the words: "the detailed semantic and syntactical analysis must be made to yield to business commonsense", as Lord Diplock put it in Amalgamated Ice Cream Co Ltd v Saigon Redererna AB (1985) 1 AC 191 at 201.

Is the apparent meaning of the words used here - "the sum actually paid" - so abundantly clear in context, does it so obviously involve actual disbursement, that, however unreasonable this result, one must so construe them?

Powerful though the arguments are to that effect, and hesitant though I am to disagree with Staughton, L.J.'s conclusions, I have finally reached the view that the words here are not so clear. I readily acknowledge that the most obvious meaning of the words is that for which the reinsurers contend.

But if it be asked how such a meaning could have been made any clearer, a simple answer is to be found in the House of Lords' decision in The "Fanti" and "Padre Island" (1992) 11 R 191 - namely, by adopting the words used in the Club rules there under consideration, whereby the Members were indemnified against claims which they "shall have become liable to pay and shall have in fact paid." I recognise, of course, the close similarity

between "the sum actually paid" and "claims which they.....shall have in fact paid". But the inclusion in The "Fanti" of the additional words "shall have become liable to pay" made it impossible to argue there, as was successfully argued before Mance, J. here, that the critical words meant just that - in that case the words so construed would have been simply tautologous; here such a construction provides an arguable alternative.

To say that words of yet clearer meaning could have been used is not, however, I accept, a sufficient answer to the submission that the words used here are themselves unambiguously clear - "clear beyond rational argument" as Mr. Pollock QC boldly contended. Additional responses need to be given. First is that, as always, the words have to be construed in their context. That context here has two aspects. One, the wider aspect, is that these words appear in an excess of loss reinsurance contract, a context in which it is unlikely that the reinsurers' duty to pay will be made conditional upon the reinsureds' prior disbursement of incoming insurance claims - as to this improbability see particularly In re Eddystone Marine Insurance Co ex p Western Insurance Co (1982) 2 Ch 423, In re Law Guarantee Trust and Accident Society, Ltd (1914) 2 Ch 617 and Home and Overseas Insurance Co Ltd v Mentor Insurance Co UK Ltd 1 Ll R 473.

The second and narrower aspect is that the words are used in an "Ultimate Nett Loss Clause", a clause which on any view is concerned essentially with the measurement of reinsurance recoveries and where it would be surprising to find imposed a

condition requiring prior disbursement.

In both these respects, be it noted, the present context differs from that existing *The "Fanti"*. There the contract was not one of reinsurance but of mutual insurance between Club Members. Perhaps more importantly, however, the critical words appeared there in the indemnity Rule itself - as an essential element of entitlement to indemnity - rather than in what is essentially a loss measurement clause. True, in the first two of the reinsurance contracts here under consideration, the Liability Clause itself provides that "The Reinsurers shall only be liable if and when the Ultimate Nett Loss sustained by the Reinsured" [reaches a certain figure] and the Reinsurers shall thereupon become liable....". But, as Mance, J. pointed out, "the focus of the clause is not on timing but on the scope and limits of the financial responsibility accepted on an excess of loss basis under the contracts." There is, moreover, no equivalent provision in the main indemnity clause of the third contract and, although clearly the appeal could be decided differently regarding that contract, no one has contended for such a result.

Mance, J. furthermore pointed out that, read literally, the Liability Clause in the first two contracts is inconsistent with the Ultimate Nett Loss Clause, there being no liability under the former to pay on an interim basis despite the clear implication to this effect in the proviso to the later clause. This to my mind is another factor justifying a less literal approach to the

words in question.

The importance of context is neatly illustrated by Mr. Kentridge QC's example of the situation between exchange and completion of contracts for a property purchase, where the buyer could well say that he had bargained down the asking price and "actually paid" something less. In that admittedly very different context the words would not connote disbursement. In the present context too, I conclude that it is possible to construe the words as not requiring disbursement but rather as emphasising that the recoverable loss must be immediately due and nett of all deductions. That I readily accept is a difficult construction, but not, I think, any more difficult than to construe "any breach" of contract as meaning "any repudiatory breach", as in *Antaios*.

This difficult construction, however, I would only finally adopt were the more obvious construction to cause plainly unreasonable results. I turn next, therefore, to consider this aspect of the case.

How (if at all) unreasonable is it to make prior payment by the reinsured a condition of indemnity under these policies? A convenient starting point is again *The "Fanti"*. There, of course, because the rules were found - indeed accepted, subject to as unsuccessful argument in equity - to provide unambiguously for prior payment, the reasonableness of that condition was ultimately immaterial. Nevertheless it was considered and two

justifications were suggested. First, that the purpose of the Rule was to prevent a member from making a profit from his insurance cover by receiving payment from the Club but failing to pay the third party. Second, a suggestion to which Lord Goff expressed himself much attracted:

".....that, in a mutual insurance association such as a P & I Club, it is essential that members should be able to assume the financial probity of other members, because all of them are insurers as well as insured. To that end it is customary to require each member to discharge his own liability before he can be indemnified against it by the Club. Each member is, after all, running his own business: it is up to him to make sure that a claim against him is well-founded, and the best way of securing that is to require him first to pay the claim before seeking indemnity from the Club."

No such justification, submits Mr. Kentridge, can exist in the context of reinsurance. Take excess of loss reinsurance against catastrophe loss. Sometimes, inevitably, the reinsured will be unable to meet the entire loss from his own pocket - that, indeed, will often be why he obtained reinsurance in the first place. It would be wholly unreasonable on that account to deny him indemnity under the reinsurance, to drive him into insolvency, and to give the reinsurer the windfall benefit of not paying without even the liability to return premiums.

That, replies, Mr. Pollock, is just rhetoric. There is no known case where the reinsured has in fact been forced into insolvency by the requirement to make prior payment of the entire loss. Provided only that he can pay his share of the loss, he will invariably be able to find (if necessary with the aid of a bank loan) sufficient in addition to pay at least part of the reinsured excess and thereby trigger at worst a process of staged recovery under the indemnity clause.

I find it helpful to consider the rival constructions in three different situations: first where the reinsured is in any event insolvent and unable to pay even his own share of the loss; second, at the opposite end of the spectrum, where without difficulty he can pay the entire loss; and third, where he can pay his own share but not easily more.

1. Insolvency

I can readily see that reinsurers might wish to provide that in the event of the reinsured becoming insolvent, indemnity - which in those circumstances would go to the general body of creditors - should not be payable, and clearly -subject only to an argument on the application of the principle in British Eagle International Airlines Ltd v Compagnie Nationale Air France (1975) 1 WLR 758 - that could be stipulated. But there was no such stipulation here, and in the one policy where the reinsured's insolvency was expressly contemplated (by Article 22 of the third contract), as Mance, J. points out:

"The message conveyed is that a reinsurers' liability for outstanding losses remains unchanged despite the reinsured's insolvency or inability to pay, even if reinsurers terminate cover in respect of future losses and a fortiori if reinsurers do not."

2. Reinsured able to pay entire loss

In this situation it really makes little difference to the parties whether prior payment is required or not. Even if it is required and made, the reinsurer comes under an immediate liability to reimburse his reinsured and accordingly gains nothing from the provision. The very fact that he must immediately reimburse the loss denies the provision any value as

a guarantee that the claim is well-founded.

3. Reinsured unable to pay entire loss

This surely is the paradigm situation and I for my part find Mr. Kentridge's argument upon it compelling, Mr. Pollock's unpersuasive. Theoretically, no doubt, the reinsured, if solvent, could seek a bank loan or otherwise pay part at least of the excess loss so as to trigger some reimbursement under the indemnity policy. But to what end? Assuming full recovery was ultimately achieved as intended under the policy, the reinsurers would have gained nothing (save perhaps very marginally postponed liability), whereas the reinsured would probably have been put to very considerable inconvenience and expense. The condition could not rationally have been imposed to achieve those consequences. It serves, in short, no legitimate (i.e. reasonable interest of the reinsurers. In reality, the only effect of introducing a condition of prior payment would be that sometimes it could not be satisfied in which event the entire object of the reinsurance contract would be thwarted and the reinsurers would receive a pure windfall gain. That cannot have been the mutual intention of the parties. I conclude therefore that such a construction of the clause is wholly unreasonable and that it must yield to business commonsense.

For these reasons, which I believe do no more than reproduce in shorter form the essential reasoning to be found in the very full and helpful judgment below, I for my part would dismiss this appeal.

Lord Justice Nourse:

The contracts out of which this appeal arises are excess of loss reinsurances. Liability under such an insurance, while it may be provisionally assessed, cannot be conclusively established until there has been a final settlement between reinsurer and reinsured, at which point the reinsured must produce an account showing that the aggregate sum paid under the insurances covered is within the excess. In practice no doubt, even at the stage of final settlement, a reinsurer will often act on the basis of sums payable by the reinsured but not yet paid. But his strict right must be to insist on actual payment, because until then his own liability is not conclusively established.

That being the nature of the insurance, how should the contracts in this case be construed? Their material provisions are fully set out in the judgment of Lord Justice Staughton. Like him, I will start with the two whole-account contracts, the first three and most important clauses of which are headed "Reinsuring clause", "Liability clause" and "Ultimate nett loss clause" respectively. The reinsuring clause provides that the reinsurance is to pay "all losses howsoever and wheresoever arising" subject, however, to the terms and conditions following. So the outcome primarily depends on the interaction between the liability and ultimate net loss clauses.

If the definition of "Nett Loss" in the ultimate net loss clause is incorporated into the liability clause, the words

"sustained by the Reinsured" being omitted as tautologous, the first part of the latter clause reads as follows:

"The Reinsurers shall only be liable if and when the Ultimate sum actually paid by the Reinsured in settlement of losses or liability [after making deductions etc.] in respect of interest coming within the scope of the Reinsuring Clause exceeds £3,000,000.
..."

Bearing in mind the nature of the insurance as I have stated it, I am unable to see why a provision headed "Liability clause" and expressed to deal with liability should not look forward to the final settlement between the reinsurers and the reinsured, at which point, as I have said, the reinsurers' liability will be established by reference to the aggregate sum that the reinsured has actually paid under the insurances covered. On this view of the matter the words "the sum actually paid" mean what they say, neither more nor less. An objection to this construction might possibly be based on the words "and when" in the first line of the liability clause. Certainly the effect might be even clearer if it read "The Reinsurers shall only be liable if the Ultimate sum actually paid etc.". But I do not think that the objection could be a good one. The words "if and when" are merely words of contingency equivalent to "in the event that". Accordingly, the inclusion of the words "and when" does not alter the effect of the liability clause.

It is then necessary to consider the second and third sentences of the ultimate net loss clause. The second contemplates that there may be "a loss settlement", necessarily an interim settlement, and it provides for all necessary

adjustments to be made thereto in respect of salvages, recoveries or payments recovered or received subsequently. The third sentence contains a proviso that nothing in the ultimate net loss clause shall be construed to mean that losses under the reinsurance are not recoverable until the Reinsured's ultimate net loss has been ascertained. Thus the second and third sentences of the ultimate net loss clause provide for what is to happen during the period before final settlement and are consistent with the view that, in contrast, the liability clause looks forward to that point. In my view none of the other provisions of the whole-account contracts has any significant role in the decision of the question that confronts us.

I turn to the third contract, which relates to aviation risks. Here the decisive provisions are contained in articles 7 and 10 headed "Reinsuring clause" and "Ultimate nett loss clause" respectively, with article 7 doubling up for the reinsuring and liability clauses in the whole-account contracts. If the definition of "Ultimate Nett Loss" in article 10 is incorporated into article 7, the first part of the latter clause reads as follows:

"This Reinsurance is to Indemnify the Reinsured, subject to its provisions, for all losses which may be sustained by the Reinsured in excess of a sum actually paid by the Reinsured in settlement of losses or liability [after making deductions etc.] of £28,000,000 ..."

Again, I am unable to see why that provision should not look forward to the final settlement between the reinsurers and the reinsured. Again, the words "the sum actually paid" mean what

they say, neither more nor less. Again, the second and third sentences of article 10 perform the same function as the second and third sentences of the ultimate net loss clause in the whole-account contracts and are consistent with the view that article 7 looks forward to the point of final settlement. Again, none of the other provisions of the aviation contract has any significant role in the decision of the question that confronts us.

By this route I have come to the conclusion that under none of the three contracts are the reinsurers entitled, before the point of final settlement, to make payment to the reinsured conditional on prior payment under the insurances covered. Not until that point do the liability clauses come into play. Until then the relationship between the parties is essentially governed, first, by the reinsurers' general obligation to indemnify the reinsured against the losses specified and, secondly, by the second and third sentences of the ultimate net loss clauses.

I am conscious that this construction of the contracts, although put briefly to Mr Pollock QC, for the reinsurers, at the end of his reply, was not canvassed in argument either in this court or before Mr Justice Mance. Yet a question of construction of a document, like that of a statute, is invariably at large; cf. Bahamas International Trust Co. Ltd. v. Threadgold [1974] 1 WLR 1514, 1525, per Lord Diplock. The first task of the court is always to construe the particular words of the particular

contract against the factual background known to the parties at or before the date it is entered into. Here it is only the nature and objective aim of an excess of loss reinsurance of which account can properly be taken. Having carried out that process of construction, I am of the opinion that the meaning and effect of the material provisions of the contracts in this case are plain. Since they result in nothing unreasonable, far less absurd, no further enquiry is necessary.

For these reasons, I agree with Lord Justice Simon Brown that the appeal should be dismissed.

