“Negligent Underwriting”: the Position After Bonner v. Cox

by David Foxton QC

Introduction

A striking feature of English common law over the last fifty years has been what Tony Weir described as “*the staggering march of negligence*” (‘*The Staggering March of Negligence*’ in Peter Crane and Jane Stapleton ‘*The Law of Obligations: Essays in Celebration of John Fleming*” (Oxford 1998)), the concept having encroached upon almost every aspect of the law of obligations. Lord Templeman decried this tendency in *China and South Sea Bank v Tan* ((1989) 3 All E.R. 839 at p.841) stating:

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

The purpose of this article is to consider one aspect of the quiet invasion of the realm of insurance law by the concept of negligence which, after a fierce battle, was ultimately resisted: the argument that a reinsured owes its reinsurer a contractual duty of care when underwriting business falling within the scope of the reinsurance. It develops a section of a talk which I delivered on this general area, entitled “*The Negligent Reinsured – A Defence for Reinsurers?”*, to the British Insurance Law Association in January 2003 and which, I am pleased to say, has played a small part in repelling the invasion.

In the realm of direct insurance, the argument that an insured owes its insurer a duty of care to avoid loss has generally failed, even in circumstances in which the policy contained language strikingly redolent of a duty to take care. The *locus classicus* on this issue was the Court of Appeal decision in *Fraser v Furman* ((1967) 1 WLR 898), holding that a clause stating that “*the insured shall take reasonable precautions*” to avoid loss merely required the insured to abstain from deliberately and recklessly exposing himself to the risk of loss, the test being subjective rather than objective. Any other construction would have been wholly repugnant to the purpose of a liability policy.

A similar ethos prevails in the construction of property policies, as evidenced by *Sofi v Prudential Assurance* ((1993) 2 Lloyd’s Rep. 591). The position finds express recognition in the Marine Insurance Act 1906, s.55(2)(a):

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

In a reinsurance context, however, the idea that the reinsured is under a duty to exercise reasonable care in his underwriting to the reinsurer surprisingly gained ground, and for a long period claims of breach of such a term featured regularly in certain kinds of reinsurance dispute. The prediction of Robert Kiln (in Kiln and Kiln, '*Reinsurance in Practice*'), 4th ed., p.426: *"How long will it be before reinsurers have yet another reason to repudiate contracts on the grounds of reckless or say incompetent underwriting"* – sadly came to be fulfilled.

Like every good story, and many a bad one, this story has a beginning, a middle and an end, the very beginning being a very good place to start.

The beginning

The starting point for the concept of a reinsured's duty appears to be Hobhouse J's judgment in *Phoenix v Halvanon* ((1985) 2 Lloyd's Rep. 599), or more accurately a concession made before Hobhouse J of which he appears to have approved. The case concerned a facultative / obligatory proportional treaty which, of course, gave the reinsured the unfettered right to cede (or not to cede) business to his reinsurer, and in the case of cession the risk would be shared in defined proportions. The judgment noted the pleading in the following terms:

> "*It was a term … of the contracts implied in the express terms …that* [the reinsured] *would conduct their business in accordance with the ordinary practice of the market and exercise due care and skill in the conduct of all business carried on under the … contracts … Those duties require* [the reinsureds] *inter alia to:*
>
> *(a) keep full and proper records and accounts of all risks accepted, or premiums received and receivable, and all claims made or notified;*
>
> *(b) investigate all claims and confirm that they fall within the terms of the contract and were properly payable before accepting them;*
>
> *(c) properly investigate risks offered to them before acceptance and closings relating thereto subsequently*
>
> *(d) keep full and proper accurate accounts showing at all times the amounts due and payable by* [the reinsureds] *to the* [reinsurer] *and by* [the reinsurer] *to* [the reinsureds] *under the contracts;*
>
> *(e) ensure that the amounts owing to them were collected promptly when due and entered forthwith in their accounts, and all balances owing to* [the reinsurer] *were likewise paid promptly when due;*

(*f*) *obtain, file or otherwise keep in a proper manner all accounting claims and other documents and records and make these available on request to* [the reinsurer]".

Hobhouse J said at p.613:

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

The justification to which Hobhouse J referred – the risk of adverse selection by the reinsured – would, it is submitted, be adequately addressed by an implied term of good faith, good faith, after all, being the foundation of insurance contracts. To say that it justifies an obligation on the reinsured not to write the underlying business negligently went too far: for example, if the reinsured owes a duty "*properly* [to] *investigate risks offered to them before acceptance*", would this mean that the reinsured could be liable in damages for wrongly turning down profitable risks which would have been ceded to the reinsurer under the treaty, and which would have reduced the overall loss?

Nevertheless, the decision was endorsed and enlarged upon.

1. The passage was approved and followed in Bermuda by Justice of Appeal George in the matter of *Chesapeake Insurance Co. Ltd*. (Bermuda Civ. App. No.7 of 1991, 28 November 1991). It may well still represent the law of Bermuda.
2. Hobhouse LJ endorsed, in passing, his own earlier judgment as a general statement of the implied terms appropriate to reinsurance in *Toomey v Eagle Star Insurance Co. Ltd* ((1994) 1 Lloyd's Rep. 516 at 523):

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

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

3. The editors of '*MacGillivray on Insurance Law'* (2003, para. 33-69) appear to lay the emphasis on selection:

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

4. The editors of Arnould – *"The Law of Marine Insurance and Average"* (Vol 3, 16th edition, London 1997, para. 397-404, note 97) also limit the term in this way**:**

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

5. Others believed that the term should not be limited to cases of selection but should apply to every proportional contract of reinsurance. O'Neill and Woloniecki in '*The Law of Reinsurance in England and Bermuda'* (second edition 2004, para. 7-09) stated:

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

However, the discussion, post *Bonner v Cox*, in the first supplement to this edition at paragraphs 4-20A-B is more circumspect, suggesting that *Bonner* has cast doubt on the *Phoenix* decision.

The next judicial consideration of the issue appears to be the unreported decision of Tuckey J. in *Economic Insurance Company Limited v Le Assicurazioni d'Italia SPA* (27 November 1996). Copies of the same original copy of this case appeared in hearing bundles for numerous arbitrations over the next 10 years, to the point where the copy had almost become illegible, and the copy bore fax transmission details for almost every firm of reinsurance solicitors in London. The Economic, through a coverholder wrote a bond to cover a contract for the supply and maintenance of

vehicles, Economic's assent being required before a risk would be written. Economic was reinsured by Assitalia. The terms of the reinsurance were complicated, but their effect was that Assitalia and the other reinsurers bore a proportionate share of every risk accepted by Economic. The bond had to be paid in full, and when Economic sought to recover Assitalia's share, Assitalia raised by way of a defence that the bond had been negligently written in breach of an implied term to conduct the underlying business with reasonable skill and care.

1. Economic argued that they owed no such duty to Assitalia: they themselves retained a retention, which gave them a common commercial interest in the risks written, and there was no process of selection by which they could determine which risks they would take on their own account and which they would reinsure.
2. Assitalia relied on *Phoenix v Halvanon* which they contended established the general position on reinsurance treaties.
3. Tuckey J held that the duty fell to be implied in any case:

   > *"where the reinsurer is bound to accept cessions without the opportunity of exercising any independent underwriting judgment of his own*".

He noted that the reinsurance:

> "*had all the essential characteristics of, say, a quota share, with Economic being bound to cede all but their retention and the reinsurers being bound to accept their proportion of all risks written by [the coverholder] on behalf of Economic*".

Nevertheless he held it was appropriate to imply the duty:

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

As the decision in *Assitalia* has not been overruled, it may be worth spending some time explaining why it is clearly wrong. One of the factors which drove Tuckey J's decision was a desire to achieve "symmetry" on the position between the coverholder and the reinsured, on the one hand, and the reinsured and the reinsurer

on the other. Noting that the coverholder undoubtedly owed its client a contractual duty of care and could be sued in damages, he believed it was necessary to protect the reinsurer against the loss which it would suffer from negligent underwriting by implying a similar term into the reinsurance.

However the analysis is flawed in a number of respects. First, the contract of agency between the coverholder and the reinsured is legally a fundamentally different creature from the contract of reinsurance. Whilst an implied obligation of skill and care is a natural component of the former, the concomitant of the remuneration paid to the coverholder for the proper performance of its duties, it is not an appropriate term of a reinsurance contract, nor can it be said to be the concomitant of the remuneration paid to the reinsurer in the form of premium.

Second, the implied term was not necessary to achieve the symmetry which drove Tuckey J's conclusion. The reinsured was entitled to recover all of its loss from the coverholder if caused by the latter's negligence, whether or not some part of that loss was reinsured (applying the conventional principle that the existence of that reinsurance cover is *res inter alios acta* so far as the coverholder is concerned). To the extent that the reinsured recovered such damages from the coverholder, it would serve to diminish its loss with the result that the claim under the reinsurance would be diminished. If no recovery had been made from the coverholder, the reinsurer would be subrogated to the reinsured's claim against the coverholder on conventional principles. The classic statement of rights of subrogation, in *Castellain v Preston* ((1883) 11 QBD 380 at 388):

> *"Now it seems to me that in order to carry out the fundamental rule of insurance law, this doctrine of subrogation must be carried to the extent which I am now about to endeavour to express, namely, that as between the underwriter and the assured the underwriter is entitled to the advantage of every right of the assured, whether such right consists in contract, fulfilled or unfulfilled, or in remedy for tort capable of being insisted on or already insisted on, or in any other right, whether by way of condition or otherwise, legal or equitable, which can be, or has been exercised or has accrued, and whether such right could or could not be enforced by the insurer in the name of the assured by the exercise or acquiring of which right or condition the loss against which the assured is insured, can be, or has been diminished."*

Third, in practice the approach adopted by Tuckey J will not achieve symmetry at all. The coverholder is likely to have limited resources, and may be unable to meet any sizeable claim for damages brought by the reinsured, whilst the reinsured will

still have to pay the claims of the policyholders under the policies negligently written by the coverholder. By contrast, the reinsurer has no credit exposure for the coverholders' negligence – its claim for damages will always operate as a set-off against the amounts otherwise payable under the reinsurance.

One classic example of the inequity of the implied term approach adopted in *Assitalia* is where the reinsured is effectively a front for the reinsurer, offering its superior credit rating to the purchasers of insurance written by the coverholder and passing on 100% of the claims to the reinsurer. If Tuckey J.'s approach is correct, the reinsured is assuming a major credit exposure by taking the role of fronting insurer, not simply the risk of the reinsurer's insolvency which is a recognised feature of a fronting arrangement, but also the risk of the coverholders' insolvency.

The middle: the Sphere Drake case and gross loss making business

The issue next received consideration in a series of arbitrations and a High Court case arising out of the Personal Accident Spirals and business placed in those spirals by SCB. In *Sphere Drake Insurance Limited and Odyssey Re (London) Ltd. v Euro International Underwriting Limited and ors* ((2003) Lloyd's Rep IR 525), Mr. Justice Thomas considered an allegation that reinsurance brokers, SCB, induced breaches of fiduciary duty by an underwriting agent, EIU, to accept business which EIU knew it was not in their principal's (Sphere Drake's) interest to accept.

In the course of the lengthy *Sphere Drake* judgment, Thomas J had to consider the position where a reinsured wrote business on terms which it knew would be loss making before reinsurance was taken into account, but which would turn a net profit by passing the major part of those losses onto its reinsurers ("gross loss-making business"). Sphere Drake, therefore, was not concerned with losses negligently caused by a reinsured to its reinsurer, but losses deliberately – or at least foreseeably – passed to the reinsurer because of the terms on which the underlying business and the reinsurance were written.

The judgment recognised that there were circumstances when a reinsured might perfectly properly write business which it was known would cause a loss to its reinsurer, Thomas J. stating at para. 153:

> *"It might be asked why any reinsurer would write such business unless it was for a common commercial purpose - such as the writing of a modest amount of unprofitable business in order to enter a market, to maintain market share or to cultivate the cedant or broker in order to obtain other business".*

Even with respect to gross loss making business which did not fall within these categories, the terms of the judgment are inconsistent with it being a term of every

contract of reinsurance that the reinsured would exercise reasonable skill and care to avoid causing the reinsurer loss. At para. 329, when describing the market in which gross loss making business was written Mr. Thomas J held:

> *"It seems to me, as I am concerned with reinsurance, that the ordinary principles of disclosure suffice. If the nature of the business was properly disclosed, then in my judgment no complaint could be made about the writing of gross loss making business on the back of reinsurance".*

There are, however, two references in the judgment which might have lent some support to the suggestion that a duty of care exists. For example at para. 257, Thomas J. summarises Sphere Drake's case that there were narrow limits within which loss making business might legitimately be accepted:

> *"Provided that there was full disclosure and compliance with the continuing duties of good faith and reasonable care owed to the reinsurer, there could be no complaint in such cases".*

At para. 299, he stated:

> *"A prudent and conventional reinsurer would not understand that any prudent and honest insurer would deliberately write gross loss making business in order to pass it on to him; he would regard this as contrary to the whole ethos of the business and a breach of the duties of care and good faith".*

The suggestion that disclosure adequately addresses the issue would only apply where the reinsured had a settled or established practice of writing gross loss making business before the reinsurances were placed (as was the case with the risks in the workers' compensation carve out market considered by Mr. Justice Thomas). It would not address the position of a reinsured who succumbed to the temptations of gross loss making business only after its reinsurances were placed.

While a reinsured would be expected to disclose a practice of writing business at premiums which were known to be below those necessary to achieve a gross profit, there could not, it is suggested, be an obligation by a negligent reinsured to disclose its own negligence (e.g. where it was inadequately rating business due to a negligent assessment of risk). A party does not "know" of his own negligence in the ordinary course of business: negligence is in its essence a judgment on conduct, not a fact, and individuals who are merely negligent, as opposed to subjectively reckless, are not generally conscious of their own failings. The proposition, taken to its logical development, is that reinsurers only insure competently run reinsureds. As McNair J

observed of a similar argument in the *Australia & New Zealand Bank v. Colonial & Eagle Wharves Ltd* ((1960) 2 Lloyd's Rep.241), at p.254:

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

The end: Bonner v Cox (Energy 77)

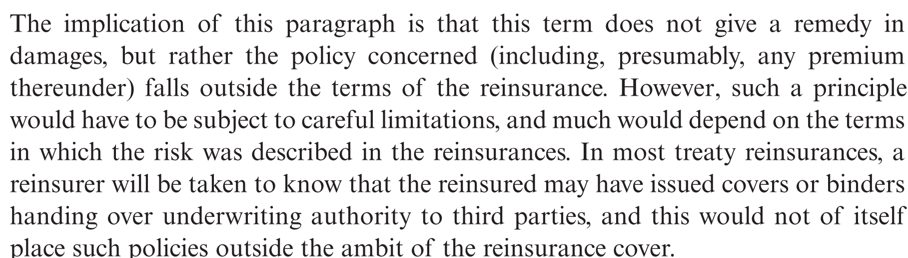
The nature of the duties owed by a reinsured to its reinsurer when accepting inwards business were finally the subject of full argument in the courts in *Bonner v Cox* ((2005) Lloyd's Rep IR 569). The case arose out of a binding authority for energy business known as the Energy 77 cover, operated by Aon, under which a group of insurers agreed to accept risks shown to and accepted by the leader, Syndicate 535.

Those insurers in turn had reinsurance (on a non-proportional basis), and the reinsurers of the Energy 77 alleged that a number of risks declared to the cover had been accepted by Syndicate 535 in breach of implied terms of the reinsurances, namely that risks would only be accepted by the reinsureds on the same basis as if there was no reinsurance. In effect, the reinsurers alleged that the Energy 77 insurers had been "writing against" their reinsurers. Morison J surveyed the authorities, and reached the following conclusions:

First, that it can never be wrong for a reinsured to take into account its reinsurance when determining whether to accept business and on what terms. This proposition is obviously correct, although the examples Morison J gave – writing larger lines or more smaller lines – are considerably less controversial than the reinsured who writes business at cheaper rates because of reinsurance.

Second, if a reinsured simply handed its pen away, writing everything that the broker put in front of him without reading it or applying its own judgment, then such policies *"fell outside the terms of the reinsurance"*, because:

> *"there must be implied into the contract a term that a policy can only be declared to the cover if it has been the subject of an underwriting decision by the lead underwriter"*.

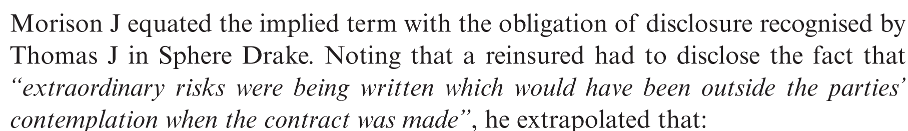


The implication of this paragraph is that this term does not give a remedy in damages, but rather the policy concerned (including, presumably, any premium thereunder) falls outside the terms of the reinsurance. However, such a principle would have to be subject to careful limitations, and much would depend on the terms in which the risk was described in the reinsurances. In most treaty reinsurances, a reinsurer will be taken to know that the reinsured may have issued covers or binders handing over underwriting authority to third parties, and this would not of itself place such policies outside the ambit of the reinsurance cover.

Third, that there was *"also room"* for a further implied term, namely:

> *"the policies to be accepted to the Cover will be those which in the ordinary course of business the lead underwriter would write, taking account of the reinsurance"*.

The ambit of this implied term was unclear, but it appeared to be a term which requires the reinsured to underwrite in accordance with the ordinary practice of the market. That would permit the underwriter to write gross loss making business when this reflects general market practice – to maintain market share when rates decline, as loss leaders or as part of a package etc – or the practice of the market in which the particular risk is written (for example the gross loss making business of the carve out market considered in *Sphere Drake*).



Morison J equated the implied term with the obligation of disclosure recognised by Thomas J in Sphere Drake. Noting that a reinsured had to disclose the fact that *"extraordinary risks were being written which would have been outside the parties' contemplation when the contract was made"*, he extrapolated that:

> *"as I see the position, such risks would not be covered in the first instance as being outside the commercial expectations of the reinsurer that he would be faced with the normal diet of risks"*.

Whilst this approach would cater for the position where the reinsured did not conceive the intention to write risks outside his *"normal diet"* prior to placement, there are difficulties with the suggestion that there would both be an obligation to disclose that the underwriting would include risks outside the parties' contemplation, whilst at the same time holding that such risks were not covered by the reinsurance. If the risks would not be covered, the intention to write them could not conceivably be material (in much the same way as there is no duty to disclose facts which are the subject of a warranty).

Fourth, Morison J rejected the suggestion that there was a duty of care, *"at least so far as excess of loss reinsurance is concerned"*. *Halvanon* and *Assitalia* were

distinguished on the basis that they were concerned with proportional reinsurance, the judge noting:

> *"Halvanon is barely authority at all since the point was not argued, and it gets no better just because it was referred to with approval in the Court of Appeal by the same judge".*

Finally, the judge was prepared to imply a term that neither party would be dishonest with the other in their dealings. Quite how this implied term interrelates with the post-contractual duty of utmost good faith – which imposes a requirement of honesty post-contract between insured and reinsurer but which does not, on current authority, give any remedy in damages – is not clear. See *The Star Sea* ((2001) 1 Lloyd's Rep. 389), and *La Banque Financiere de la Cite v Westgate Insurance Co. Ltd.* ((1988) 2 Lloyd's Rep. 513; (1990) 2 Lloyd's Rep. 377 at pp.387-8).

The editors of O'Neill and Woloniecki, "*The Law of Reinsurance*" (first supplement to the second edition, para. 4-20B) suggest that the term proposed by Morison J is arguably inconsistent with the decisions on the post-contractual duty of utmost good faith, but it is suggested that a contractual duty of good faith arising by way of an implied term of the contract has an entirely distinct and separate legal foundation from the duty of utmost good faith enshrined in section 17 of the Marine Insurance Act 1906, and is not circumscribed by the limited remedies available for breach of the latter duty. This is an argument developed in my contribution to "*Marine Insurance, the Law in Transition*" (Rhidian D Thomas, London, T&F Informa, 2006) and which derives support from *Goshawk Dedicated Ltd. v Tyser & Co. Ltd* ((2006) 1 Lloyd's Rep 566), considered below.

The decision in *Bonner v Cox* went to the Court of Appeal ((2006) Lloyd's Rep IR 385) which now provides the definitive word on whether a reinsured owes its reinsurer a duty of care when writing risks covered by the reinsurance.

At the outset, the Court of Appeal drew a fundamental distinction between proportionate and non-proportionate reinsurance, stating (at page 388):

> *"*[Reinsurance] *may be proportional, such as a quota share which is in the nature of a joint venture between the reinsured and his reinsurer. Or it may be non-proportional, such as an excess of loss, which is written to protect an exposure to a particular risk (facultative), a particular class of risk or a whole account; it is a way in which an underwriter manages an underwriting account. The fundamental difference between these two types of reinsurance is that the former involves a sharing of risks (premium and losses) between reinsured and reinsurer. The latter (which was the subject of the present case) does not".*

The Court then reviewed the authorities. Considering *Halvanon*, the Court noted that this concerned proportional reinsurance, and that Hobhouse J was not suggesting that an implied term was appropriate in all forms of reinsurance. The case did not support the implication of such a term into the excess of loss contracts under consideration. Turning to *Assitalia*, the Court held this case was also concerned with proportional reinsurance: indeed the Court accepted Mr. Boswood QC's submission that this was essentially akin to a co-insurance (whilst noting that the issue of whether a leading underwriter owed a duty of care to the following market or whether co-insurers owed each other a duty of care was not something which arose on the appeal, and that conflicting sentiments had been expressed on the former issue by Hirst J in *The Leegas* ((1987) 1 Lloyd's Rep. 471 at 475) and by Mance J in *Roar Marine Ltd. v Bimeh Iran Insurance Co.* ((1998])] 1 Lloyd's Rep. 423 at 430).

Reference was made to Thomas J's decision in *Sphere Drake*, which the Court clearly believed was inconsistent with any such duty, accepting, as it did, a reinsured's right to profit from those who knowingly enter a market they do not understand, are imprudent or who miscalculate (a view described by Mr. Gruder QC for the reinsurer as *"the law of the jungle"*). Finally reference was made to a comment by Lord Millett in *Aneco v Johnson & Higgins* ((2002) 1 Lloyd's Rep. 157) at p.192 that:

> *"Fac. Oblig. Treaties are naturally less attractive to reinsurers than quota share treaties. They are subject to the obvious risk that the insurer will retain good business for his own account and cede poor business to the treaty. There is, or at least is assumed to be, no obligation of good faith on the part of the ceding party when exercising his discretion to cede or retain a risk. The only constraint is that he must exercise some restraint if he wishes to maintain a good reputation in the market, and hope of doing future business with existing and prospective reinsurers"*.

The Court concluded that it was *"self-evident"* that there was no case which decided that a reinsured owed a duty of the kind contended for *"to his excess of loss reinsurers"*. They noted complications which would arise if the term sounded in damages – would the damages be for a difference in premium if the risk was inadequately rated or for any loss sustained, could claims for contributory negligence be advanced?

The Court concluded that for non-proportional reinsurances, neither party owed a duty to protect the interests of the other, and there is nothing wrong in an underwriter taking advantage of an advantageous reinsurance contract. A reinsurer was entitled to a fair presentation on disclosure of the type of business a reinsured

has written or proposes to write. The reinsurer could seek further protection in the contract if it wished to do so. However, there was no duty on the reinsured to act prudently or reasonably carefully.

The Court rejected Morison J's proposed implied term only to accept risks to the cover which the underwriter would write in the ordinary course of business, saying there was no necessity for such a term (the reinsurer being sufficiently protected by the obligations of disclosure and the express terms defining the business to be written), and it was too uncertain. The Court also rejected Morison J's suggested term that business would be written in accordance with the ordinary practice of the market. The Court considered whether there was an implied term, reflecting Marine Insurance Act 1906, s.55(2)(a), that business would not be written recklessly, stating:

> *"'Dishonesty', 'willful misconduct' or 'recklessness' might provide a basis on which a reinsurer could refuse to accept a risk, for example if the underwriter exercises no underwriting judgment at all in accepting a risk, not caring whether it was good or bad, or deliberately took a risk knowing of a loss which would only fall on his reinsurers, or took a bribe to write the risk, a remedy might well be available. But if this is to be so we would think it likely to be on the basis that on the proper construction of the policy such a risk would not be covered at all. But whether this is via pure construction or an implied term, or indeed whether it is right at all, is not fruitful to explore further in this case".*

The Court did not comment on the duty to act honestly which Morison J had found.

The Court concluded:

> *"We think that the reinsurance was not subject to any of the implied terms contended for. We would reach the same conclusion in respect of any non-proportional reinsurance. We do not have to decide and we do not decide whether the same applies to proportional reinsurance. We understand Phoenix v. Halvanon to be a case of proportional reinsurance. Economic certainly was. It is therefore unnecessary to overrule these cases".*

Ironically, at the same time at which the Court of Appeal was distancing itself from *Phoenix v Halvanon* in *Bonner v Cox*, a differently constituted Court of Appeal approved the decision of Hobhouse J in *Phoenix* to rely on the *uberrimae fidei* nature of the reinsured-reinsurer relationship as a reason to imply terms into a reinsurance contract, albeit not terms concerned with underwriting with reasonable care and skill *(Goshawk Dedicated Ltd. v Tyser & Co. Ltd* ((2006) 1 Lloyd's Rep. 566), implying a term that the insured would provide insurers, post-contractually, with the

documents held by the broker in respect of placing, claims and accounting documents).

Conclusion

Where does that leave the law? I tentatively suggest the following summary:

In the context of non-proportional reinsurance, the concept of a duty of care in underwriting has been firmly refuted. That leaves the question of whether such a duty can survive in proportional reinsurance? This point was expressly left open in *Bonner*; the authorities on which it rested (*Phoenix* and *Assitalia*) have not been overruled, and there are many passages in *Bonner* stressing the fundamental differences between the two types of reinsurance and the "joint venture" nature of proportional reinsurance which might be said to offer some support for the survival of the duty in contracts of that kind. Against that, certain of the criticisms expressed in *Bonner* of such a term – for example the parties' ability to make their own provision – apply equally to proportional and non-proportional reinsurance.

Two of the leading textbooks on reinsurance law express different conclusions: Barlow Lyde & Gilbert's "*Reinsurance Practice and the Law*" (paras. 5.3.2.2, 15.3.1) suggests that the implied terms in *Halvanon* probably remain good law for proportional reinsurance contracts. Butler & Merkin's *"Reinsurance law"* (para. B89-89/3) suggests the contrary.

In my view, the duty should not survive in proportionate cover either. Otherwise, instead of sharing the fortunes of their quota share reinsured, the quota share reinsurers would be considerably better placed because they would not bear the consequences of negligent underwriting. Where, however, the quota share reinsured has a claim against a third party in relation to the negligent underwriting (for example a coverholder), the quota share reinsurers will be subrogated to the reinsured's claim against that third party. Were there to be such a term, the reinsurer would be better off in respect of business participated in by way of quota share than in respect of business which it wrote itself: it would be visited with the consequences of negligent underwriting in the latter case, but would effectively be guaranteed no "sub-standard" underwriting in the former case.

What of other duties? My own view is that under a fac/oblig treaty, under which the reinsured can decide which risks to retain gross for his whole account, and which to cede to its reinsurer, there is an implied (contractual) term of good faith to prevent "dumping", notwithstanding the passage to contrary effect in *Aneco v Johnson &*

Higgins ((2002) 1 Lloyd's Rep. 157). However, if such a term exists it is probably not one which does give a remedy in damages, but merely a condition to a valid cession.

Under any form of treaty reinsurance except fac / fac reinsurance – whether fac / oblig, oblig / oblig, proportional or non-proportional – the reinsured will have a duty to disclose any settled underwriting practice or intention which does not accord with the ordinary practice of the market, but this does not extend to disclosing the reinsured's own negligence or incompetence. With a fac / fac reinsurance, the reinsurer will make a separate decision on each cession, and so no requirement of disclosure should arise.

The problems of how the law should respond to the reinsured who writes risks at rates which will cause his reinsurer a certain (or expected) loss remain. Jeffrey Gruder QC, in an article entitled "*Writing Against: the Law after Bonner v Cox*", *Insurance and Reinsurance Law Briefing*, Sweet & Maxwell Issue 114, April 2006), suggests that a reinsured will not be entitled to cede gross loss-making business without the express consent of its reinsurer, suggesting that *Bonner v Cox* confirms this.

Even leaving aside the difficulty in suggesting that there can be both a duty to disclose such a practice and that such risks would not be covered by the reinsurance in any event, there is no unequivocal approval for this approach in *Bonner v Cox*. The examples the Court gives – exercising no underwriting judgment at all, or writing a risk knowing of a loss which would *"only"* fall on the reinsurer – are extreme, and it is merely observed that *"a remedy might well be available"*. Moreover the difficulties of delineating acceptable and unacceptable conduct remain: is it said a risk written on a "gross loss making" basis as an "oblige" to secure better business or as part of a package, or to enter into a new market, or because it is the only way of staying in a market at all at a time of intense competition, will not be covered by the reinsurance? Finally, it is difficult to reconcile this limitation with the apparent acceptance in both *Sphere Drake* and *Bonner v Cox* that a reinsured is entitled to exploit an advantageous reinsurance contract, and that it is for the reinsurer (assuming he has had a fair presentation of the risk) to look after himself.

The remedy floated in *Bonner* - that such risks might not fall within the reinsurance, either as a matter of construction or due to the implication of an implied term – gives some indication of the likely approach in this area. It suggests that a reinsurer will not have a remedy unless the risks accepted by the reinsured are so fundamentally different from what would reasonably have been expected that they can be said to fall outside the class of business which the reinsurer has agreed to accept: effectively something akin to the concept of "material alteration in risk",

albeit one which has the effect of excluding those risks from the reinsurance rather than discharging the reinsurance. In *Kausar v Eagle Star Insurance Co Ltd* ((2000) Lloyd's Rep IR 154), Saville LJ defined the doctrine of material change in risk in the following terms:

> *"Without the further agreement of the insurer, there would be no cover where the circumstances had so changed that it could properly be said by the insurers that the new situation was something which, on the true construction of the policy, they had not agreed to cover."*

I have one final reflection about the brief life of the implied duty of care on the reinsured in a reinsurance contract. In my own experience, and those of colleagues in Chambers which I canvassed, this appears to have been a point which was frequently run in arbitrations, but never succeeded on the facts. This is not, I suggest, a testament to the high quality of underwriting seen in the London market, or in contracts which provide for arbitration in London, but a reflection of the fact that the market professionals involved in insurance and reinsurance arbitrations never bought into the argument that a reinsurer should be able to avoid paying claims where its reinsured had acted negligently by accepting risks. For this reason, I think it very unlikely that there will ever be an attempt to formulate in the express terms of standard reinsurance wordings an obligation to exercise reasonable skill and care in writing risks.

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