Neutral Citation Number: [2007] EWCA Civ 1208

Case No: A3/2006/2469

IN THE SUPREME COURT OF JUDICATURE
COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE HIGH COURT OF JUSTICE
QUEEN'S BENCH DIVISION
COMMERCIAL COURT
THE HONOURABLE MR JUSTICE MORISON
2004 FOLIO 1056

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 22/11/2007

Before :

THE RIGHT HONOURABLE LORD JUSTICE DYSON
THE RIGHT HONOURABLE LORD JUSTICE LONGMORE
and
THE RIGHT HONOURABLE LORD JUSTICE THOMAS

- -

Between :

AIG EUROPE (IRELAND) LIMITED	**Respondent/ Claimant**
- and -	
FARADAY CAPITAL LIMITED	**Appellant/ Defendant**

- -
- -

Mr Jonathan Sumption QC & Mr Peter MacDonald Eggers (instructed by **Clyde & Co LLP**) for the **Appellant**
Mr David Foxton QC (instructed by **Chadbourne & Parke**) for the **Respondent**

Hearing dates : 18th October 2007

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Judgment

Lord Justice Longmore:

Introduction

1. Once again this Court is called upon to construe a standard form Claims Co-operation Clause in a reinsurance policy which is apt for property damage insurance but inapt for liability reinsurance. In liability reinsurance, insurers (and therefore reinsurers) respond to assertions of liability by third party claimants, or, in other words, claims. A liability insurer needs to know when a claim is made against his insured and this requires notice of such claim (or sometimes of a circumstance which may give rise to a claim) before he is required to respond. The giving of such notice may be a condition precedent to his liability. One would therefore expect a reinsurance of a liability insurer likewise to require notification of a claim (or a circumstance). It appears that some reinsurers do not always require a notification of this kind but instead require notification when their reinsured has "knowledge of a loss". While this might be appropriate for reinsurance of a ship, a house or a work of art when destruction, damage or theft is obvious and will constitute a loss which an insured or a reinsured can be said to "know", it is much less appropriate for insurance of liability since a loss cannot readily be "known" until a claim that the insured is liable is disposed of by admission or adjudication.

2. So in *Royal Sun Alliance v Dornoch* [2005] EWCA Civ 238 [2005] Lloyds IR Rep 544 in which the Claims Co-operation Clause required notification within 72 hours of knowledge of a loss which might give rise to a claim, this court (affirming Aikens J) held first that the relevant loss was that of the third party claimant seeking to recover from the original insured but, secondly, that no loss would be "known" until the insured settled the claim. Before the settlement the loss was an "alleged" loss and would not, therefore, be "known" to be a loss. That was a case where it was alleged that the directors of a company (Coca-Cola) insured under an E & O policy had made false statements which caused the value of company shares to be artificially inflated. When the falsity of the statements was discovered, shareholders brought a claim for the difference between the artificially high value of the shares and their true worth. Coca-Cola denied making any false statements and asserted that the different values of the shares were caused by ordinary market fluctuations. In these circumstances, the reinsured could not have "knowledge" of any loss and the Claims Co-operation Clause was not triggered. Reinsurers argued that such a conclusion rendered the clause entirely useless in the very circumstances when it should be operative but this court held that, in the circumstances of the case, the reinsured could not know that there had been a loss before it was ascertained by the fact of settlement.

3. The facts of the present appeal have a superficial resemblance to *Royal Sun Alliance v Dornoch*. The underlying insurance policy is, again, a Directors E & O Policy and thus constitutes insurance against the liabilities of the directors of the company and of the company itself, in this case a U.S. company called Smartforce which provided course work and materials for what is known as "e-learning". Again it is alleged by shareholders that as a result of financial statements (made in this case in the company accounts) the value of the company shares was artificially inflated beyond their true worth. The (perhaps critical) distinction from the Coca-Cola litigation is that on 19th November 2002, Smartforce, before the stock market opened for business in New York, made an announcement that they intended to re-write the previous three years' accounts and gave four separate reasons for that intention. These reasons included:

1) revenue from arrangements for re-sale should have been recognised only as payments were received from the re-seller;

2) revenue recognised from shipment of software under contracts with payment schedules extending over several years should have been discounted to recognise the time value of money rather than in full at the moment of shipment;

3) revenue from several other long-term contracts should not have been recognised on execution of those contracts, but rateably over the contract period;

4) the bad debt reserve needed to be upwardly adjusted.

4. Not surprisingly the company's shares lost a third of their value on 19th November falling from $4.63, the closing price on 18th November, to $3.07, the closing price on 19th November. During that day the price had fallen to $2.50 but there was a rally before the market closed.

5. As in the Coca-Cola case, shareholders instituted proceedings against Smartforce and its directors. These were no less than 6 class suits which were eventually consolidated into one single action. The company's liability insurance policy required notification of a claim within 30 days and that notification was duly given to the company's liability insurers (AIG Europe (Ireland) Ltd ("AIG")). For some reason that notice was not passed on by AIG to their reinsurers. The U.S. action was in due course settled for $30.5 million, AIG gave notice to reinsurers within 30 days of that settlement but one of the reinsurers Faraday Capital Ltd ("Faraday") has relied on the wording of the Claims Co-operation Clause in the reinsurance policy in the following terms:-

> "Claims Co-operation clause
>
> Notwithstanding anything contained herein to the contrary, it is a condition precedent to any liability under this Policy that:
>
> a) The Reinsured shall upon knowledge of any loss or losses which may give rise to a claim, advise the Reinsurers thereof as soon as is reasonably practicable and in any event within 30 days …
>
> b) The Reinsured shall furnish the Reinsurers with all information available respecting such loss or losses, and shall co-operate with the Reinsurers in the adjustment and settlement thereof."

Faraday allege that once Smartforce had announced their intention to re-write the last 3 years' accounts and the share price had fallen by a third on the day of the announcement there was a loss which might given rise to a claim and, when AIG had been notified by Smartforce that a claim had been made against them, that loss was "known" to AIG.

The judgment

6. The judge following the *Dornoch* case held that the word "loss" in the Claims Co-operation Clause could not mean an alleged or potential loss, and that a claimant could not be said to have suffered a loss until it had been proved that he had bought shares at a value which was inflated due to the default of the company's directors or officers in the execution of their duty (paragraph 24(3)). He concluded at paragraph 60 by saying:-

> "In my judgment, the loss which is referred to in the Clause is the loss of the claimants attributable to the acts or defaults of the Insured for which there was cover under the underlying policy."

He accordingly held that since it was not proved that any fall in the value of the shares was attributable to any act or default of the company's directors until Smartforce settled the claim for $30.5 million on 23rd March 2004, AIG's notice to Faraday of 19th April 2004 was within the 30 days specified in the clause and AIG could, therefore, recover from reinsurers.

Submissions

7. For Faraday Mr Sumption QC's submissions were that

1) although "loss" meant "actual loss" rather than "alleged loss", there had been a loss which "might give rise to a claim" once the share price fell as a result of Smartforce's announcement that it intended to restate the company's accounts;

2) that loss was "known" to AIG once they had been notified that a claim in respect of that loss had been made against Smartforce, their insured;

3) the test for such "knowledge" was objective in the sense that AIG must be deemed to know what any reasonable insurer would have known in the circumstances of this case;

4) the judge was wrong to decide (or to hold that the *Dornoch* case decided) that the loss had to be attributable to the fault of the company officers and, accordingly, be recoverable under the original insurance policy.

For AIG Mr Foxton QC submitted that

1) there could be no loss unless and until it was established that the claimants had purchased their shares at an artificially high price;

2) it was this that AIG had to "know" for the purpose of the clause, otherwise the fall in share value could have been mere market fluctuations;

3) while the test for knowledge was objective, AIG could not "know" that there had been a loss based on the fact that purchases had been made when the share value was artificially high until Smartforce had admitted or acknowledged that loss by settling the claimants' claims;

4) it was not necessary to decide whether the judge was right to hold that the loss had to be attributable to defaults of company officers which were covered by the underlying policy.

"Loss"

8. It is the first of each of these submissions which is, in my judgment, critical. In the *Dornoch* case it was held that there could be no "loss" unless it was established that the shares had been bought originally for an artificially high price. It was so held because there was no event (apart from such artificial inflation) which could trigger any loss; the fall that occurred in the share value could just as easily have been the result of normal market fluctuation or market perceptions of the normal kind as much as anything else.

9. The facts, of this case are, however, different. There was a positive event which covered a substantive drop in the share price viz the announcement on 19th November 2002 of the intention to restate the company's accounts. That announcement was followed by a fall in the share price of as much as one-third of the share value. To say that that was (or might have been) coincidence or market fluctuation would be to shut one's eyes to the obvious.

10. This conclusion is not assailable by showing that the share price later rose again. Mr Foxton was, in fact, able to show that by June 2003 the share price had risen back to its original 18th November price of $4.63. That was even before the restated accounts were filed with the U.S. authorities on 22nd September 2003. He was further able to show that in January 2004, shortly before a mediation which led to the settlement of March 2004, the price had risen further to $8.83 per share. But this is, to my mind, irrelevant; there was still an undoubted loss which occurred on 19th November 2002.

11. It has to be remembered that the loss envisaged in the clause is not (or not necessarily) the loss which will in due course constitute the claim. What the reinsured has to know is

> "any loss or losses which may give rise to a claim."

On any view the sharp fall in the share price on 19th November 2002 was, looking at the matter from the shareholder's point of view, a "loss"; on any view that was a loss which "might" give rise to a claim. It did, in fact, give rise to numerous claims which Smartforce decided in due course to settle for $30.5 million for reasons which, no doubt, seemed to them to be good reasons.

"Knowledge"

12. It is also true to say that this "loss which may give rise to a claim" was "known" to AIG. It was, as they knew, a loss which had in fact given rise to a claim. They knew that when Smartforce notified them in late December 2002 that claims had been made against them. There was no reason why AIG could not have notified reinsurers within 30 days of that date and, indeed, every reason why they should have done so if the clause was going to work as intended.

13. I have already mentioned that there was a mediation which led to a settlement of the claimants' claims. AIG and Smartforce exchanged copies of their "mediation statements" in March 2004 and they were, quite properly, available to the court below in this case. On 15th March 2004 (itself more than 30 days before AIG notified reinsurers on 19th April 2004) AIG received Smartforce's mediation statement which expressed the view that damages should be less than $75 million and added

> "the stock price drop on the day the restatement was announced, $1.56, cannot be entirely attributed to the restatement."

There was no suggestion that the claimants had suffered no loss. AIG's own mediation statement of 19th March 2004 said this:-

> "The subsequent restatement of those financial statements by Smartforce arising from the discovery of financial and accounting errors resulted in significantly increased losses … . AIG recognises that the insureds faced significant potential exposure in connection with the underlying lawsuits."

Again there is no suggestion that there was no loss at all; it was being accepted that there was a loss which had given rise to a claim. The only question was whether Smartforce were liable for the loss which had occurred or any part of it.

14. There was, moreover, oral evidence from AIG's monitoring and coverage counsel Mr Kuffler, which was intended to assist the judge at the trial. In answer to questions from Mr MacDonald-Eggers on behalf of reinsurers he recognised that the accounts of 1999 – 2002 contained errors which were corrected by the restatement and he acknowledged not only that the share prices went down but also that some portion of that drop was to be attributed to the restatement (page 76 line 25). He accepted also that the parties' assessments of damages were on the basis of the fall in share prices on the 19th November 2002 (page 95 lines 14-18). On any view once liability was accepted, some damages were going to have to be paid (pages 93-94). The only question was whether Smartforce was indeed liable to the third party claimants and, from AIG's point of view, whether AIG were liable under the policy. But that there was a loss which might give rise to a claim was unquestioned.

Other matters and conclusion on the issue

15. In these circumstances it is clear that AIG knew that there was a loss which might give rise to a claim. It is, therefore, unnecessary to decide whether reinsurers, under this form of clause, have to prove subjective or objective knowledge. It is right to record that Aikens J at first instance in the *Dornoch* case thought that objective knowledge was enough. But it was unnecessary for that question to be addressed at the appeal; nor is it on this appeal. I am far from saying Aikens J was wrong, but I would prefer to decide the question in a case where it mattered. Since insurers are, of course, knowledgeable people it will be a rare case indeed in which an insurer did not know of a loss in circumstances when any knowledgeable insurer would have done.

16. The judge decided the case in favour of the reinsured on the basis that they had to know that the loss was attributable to defaults of the officers of the reinsured which

were covered by the policy. With respect to him, however, there is no warrant for that conclusion in the wording actually used. Indeed it is inconsistent with the concept of a "loss which may give rise to a claim".

17. I cannot, therefore, agree with the judge and would hold that AIG did know of a loss which might give rise to a claim much earlier than 30 days before they actually notified reinsurers on 19th April 2004 and, probably, soon after they were themselves notified of the claim by Smartforce on 4th December 2002. It follows that Faraday are entitled to judgment on this issue.

The alternative argument

18. Reinsurers had an alternative argument that in the course of the negotiations for the reinsurance the reinsurance broker and the reinsurers had agreed that the word "loss" was to mean (or at least include) "alleged loss". But neither side called any oral evidence on this question at the trial and when Mr Sumption showed us the documents on which he relied for the purpose of this submission, the argument came apart in his hands. The broker's note of 18th April 2002, which supposedly recorded this oral agreement, stated that the reinsurers' acceptance was conditional on a revised Claims Co-operation Clause "to give notification of a circumstance as and when it happens to AIG not just for the reinsured layer i.e. 5 x 5". Four days later that was again confirmed by the broker saying to AIG "A condition of the fac, is that we advise the reinsurers of any notification on the account as soon as we are made aware". This was achieved by deleting the words "under this reinsurance" from the printed forms of Claims Co-operation Clause thus making it clear that the reinsured were not to delay notification until the reinsurance (being an excess layer) was likely to have to respond. But nothing of this constitutes an agreement that the word loss was to mean an alleged loss. What does appear to have been arguably agreed is that notification would be given by AIG to reinsurers when they received notification from their insured. If that was in fact the agreement but, by mistake, it had not been included in the policy, a claim for rectification could perhaps have been mounted. But it never has been.

Final Conclusion

19. As it happens, reinsurers do not need the alternative argument. I would allow the appeal and enter judgment for the appellant.

Lord Justice Thomas:

20. I agree.

Lord Justice Dyson:

21. I agree also.