Neutral Citation Number: [2006] EWHC 2707 (Comm)

Case No: 2004/1056

IN THE HIGH COURT OF JUSTICE
QUEEN'S BENCH DIVISION
COMMERCIAL COURT

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 31/10/2006

Before:

THE HON MR JUSTICE MORISON

- -

Between :

AIG EUROPE (IRELAND) LIMITED	**Claimant**
- and -	
FARADAY CAPITAL LIMITED (on its own behalf and on behalf of the underwriting members of Lloyd's syndicate 435 for the year 2002)	**Defendant**

- -
- -

Mr David Foxton (instructed by **Chadbourne & Parke**) for the **Claimant**
Mr Peter MacDonald Eggers (instructed by **Clyde & Co**) for the **Defendant**

Hearing dates: 17, 18 and 19 July 2006

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Judgment

The Hon. Mr Justice Morison :

1. This is a dispute between Insurers [AIG, the Claimants] and their Reinsurers [The Faraday (Corporate) Syndicate, the Defendants]. The reinsurance contract between the parties contained a Notification of Loss/Claims Co-operation clause in terms which are familiar to the courts:

"*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."

2. AIG say that they are entitled to an indemnity under the Reinsurance Policy; Faraday say that the condition precedent was not fulfilled and therefore they have no liability under the Policy.

3. The background to this dispute may be shortly stated. AIG had provided cover to a company called Smartforce under a 'directors and officers' policy. This underlying Policy was expressed to be subject to Irish law. Smartforce was an Irish company which provided "e-learning" courses and reference material for the IT industry. It was listed on the NASDAQ exchange. Under the underlying Policy there were various retentions. For present purposes the relevant retention is to be found in endorsement number 5 which provided cover for "securities claims" in the USA or Canada: the retention in relation to this aspect of cover was US$5 million and a requirement for co-insurance of 25% so that AIG were liable only for 75% of a loss in excess of US$5 million and there was an overall limit to the cover of US$15 million [excess the retention].

4. In relation to its exposure, AIG did not reinsure in respect of the first layer, that is US$5 million in excess of the retention, but in relation to the next layer of US$5 million [excess of US$5 million excess of the retention] it obtained reinsurance cover in relation to 50% of its exposure from Faraday and Brit, who each took 50% of that risk, leaving each of them with a 25% exposure to claims which 'hit' this layer.

5. In relation to AIG's exposure at the top layer [US$5 million excess of US$10 million excess the retention under the Smartforce Policy] again this reinsurance cover was placed equally between Faraday and Brit who, between them covered 50% of AIG's exposure at this level.

6. In relation to AIG's remaining exposure of 50% at each of the two layers, that was covered with a Swiss Re reinsurance Policy.

The claim under the Reinsurances

7. On 6 September 2002, Smartforce merged with a USA corporation, Skillsoft. The Underlying Policy was converted into a run-off policy covering risks arising out of claims made during an increased policy period of 6 years in respect of wrongful acts before the date of the merger. On 19 November 2002, the management of the new merged enterprise announced that they intended to restate the financial statements of Smartforce for the previous three years [1999, 2000 and 2001] and for the first two quarters of 2002. These disclosures and the subsequent fall in the listed value of Smartforce's shares led to class actions against Smartforce and various of its directors. The disgruntled shareholders were alleging that they had bought their

shares at an artificially inflated value which the November disclosures then exposed and they had lost money as a result. These claims were eventually settled following a court ordered mediation in March 2004. A payment of US$30.5 million was made to the class action plaintiffs.

8. On 2 June 2005, AIG paid Smartforce's claim under the Policy for the full limit of US$15 million and then sought to recover under the reinsurances. All but Faraday have paid up. Faraday say, in a nutshell, that

(1) the losses were notified to them too late;
(2)when properly construed, the clause obliged AIG to notify Faraday of circumstances that might give rise to a claim against Smartforce, as well as actual losses, and that this was not done "*as soon as reasonably practicable*" or *"within 30 days"* of AIG's knowledge of the same.
(3) Even if the clause only covers actual losses, AIG were aware of the losses when the shares fell in value [there is a separate argument about defence costs];
(4) in any event the losses were not notified "*as soon as reasonably practicable*" even if they were notified within 30 days.

9. Before turning to the issues in more detail, I shall first deal with what I consider to be the proper construction of this clause. There was some evidence to which my attention was drawn which related to the negotiations between the parties and to the internal views of Faraday staff as to what the clause in question meant. The original draft clause [the wording was standard wording produced by JLT, AIG's brokers] was this:

"*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 <u>under this reinsurance</u>, advise the Reinsurers thereof as soon as is reasonably practicable and in any event within 30 days .."*

10. In the signed slip, Faraday deleted the words underlined. There is a note made by the brokers which indicated that the reinsurers wanted to receive advice "*as and when it happened to AIG and not just for the r/i layer i.e. 5 x 5"* Neither the broker who wrote this note nor Faraday's underwriter gave evidence. It seems to me that I should take the words of the clause as they finally appear from the agreed contract [the slip]. The intention of the parties is to be derived from the words they used to express their bargain, and I am reluctant to pay any attention to the negotiations since, like Mummery LJ in *Beazer Homes Limited v Peter Stroude* [29005 EWCA 265 at paragraphs 12 and 26:

> *12. The basic legal principles are not in dispute: evidence of negotiations leading to the making of a contract or of the subjective intentions of the parties as to the meaning of the contract is not admissible for the purpose of construing the contract:* ***Prenn v. Simmonds*** *[1971] 1 WLR 1381 per Lord Wilberforce at 1384C-1385H;* ***Reardon Smith Line v. Yngvar Hansen-Tangen*** *[1976] 1 WLR 989 per Lord Wilberforce at 996E-997D ; and* ***Investors Compensation Scheme v. WBBS*** *[1998] 1 WLR 896 per Lord Hoffmann at 912F-913F. Such evidence is not admissible as part of the factual matrix or as relevant objective background of a contract, as it is not helpful in construing a contractual document.*
>
> *26. The policy underlying the exclusion of that evidence applies also to evidence of the negotiations and subjective intention of the parties relating to a separate agreement, such as the negotiations for a collaboration agreement between Mr Stroude and BHL which failed to produce a concluded agreement. As evidence of the purpose, meaning and scope of the s106 Agreement, the draft collaboration agreement, the abortive negotiations for it and the subjective intentions of Mr Stroude and BHL in relation to it are quite simply worthless. In some very loose sense they could be described as "background" to the s106 Agreement, but they are far from being the factual matrix or objective setting of the s106 Agreement which Lord Wilberforce and Lord Hoffmann described. Indeed, I would go further than saying that the evidence sought to be adduced is not helpful on the construction issue. Like much material that is irrelevant or only marginally relevant, this evidence is distracting and detrimental to the legal process: it is time wasting, cost consuming and diverts attention away from what matters most when construing a formal written contract, namely, the language which the parties have agreed upon to express their contractual intentions.*

11. To be fair, Mr Macdonald Eggers, who represented Faraday's interests with conspicuous ability, did not press the point. His submission was that

> (1) AIG must have had actual knowledge of a "loss or losses".
> (2) In the context of a liability policy, the loss or losses must be those borne by the plaintiff shareholders, not AIG.
> (3) The loss or losses must be capable of giving rise to a claim (this is merely a matter of possibility as opposed to probability).
> (4) The possibility of a claim must be one under the Original Policy.

12. His alternative submission was that the word "loss" meant "potential loss" in order to give the second part of the clause some efficacy.

So, the question remains, what is the proper construction of the clause?

13. As I have indicated this was a standard clause in common use. A similar clause was considered by the Court of Appeal in *Royal & Sun Alliance Plc v Dornoch* [2005] 1 Lloyd's Law Reports IR page 544. The clause in that case was in these terms [and I underline the differences]:

> "*Notwithstanding anything herein contained 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 under this policy, advise the Underwriters thereof by cable within 72 hours*
> >
> > *(b) The reinsured shall furnish the Underwriters with all information available respecting such loss or losses and the Underwriters shall have the right to appoint adjusters, assessors and/or surveyors and to control all negotiations, adjustments and settlements in connection with such loss or losses.*

14. At first instance, Aikens J. [2004] Lloyd's Law Reports IR page 826, held that the word "loss" meant the "actual loss". He considered the various possibilities as to whose loss was being referred to in paragraph 62 of his judgment:

> "*Mr Sumption submits and Mr Harvey accepts that there are three possible answers to the question: whose "loss or losses" are being referred to in the CCC? The losses will occur sequentially. In chronological order the possibilities are: (i) the losses of claimants against the original insured (i.e. in this case, respectively: the claimants in the Class Actions against Coca Cola and its Directors and officers). Such losses may lead to: (ii) losses of the original insured (i.e. here Coca Cola and its Directors and officers), which occur when they have been held liable to the third party claimants. Such losses would be recoverable under the original insurance. In this case the losses of Coca Cola and its Directors and officers which arise from claims by third parties will be losses that are recoverable under the MSP. Those losses can lead to (iii): losses of the original insurer, i.e. in this case RSA, because it has become liable to pay the insured under* ***Section V*** *of the MSP.*

15. Neither party favoured the third possibility; the reinsurers, represented by Mr Harvey QC, who were refusing to pay, submitted that it was the "actual loss" of the claimants in the action against Coca Cola; Mr Sumption QC, for the reinsured, submitted that the clause was referring to Coca Cola's loss. Eventually, the Judge concluded [paragraph 86] that the words "*loss or losses*" "*refer to the actual loss or losses of third party claimants against the original insured*."

16. Having identified the meaning of the words *"loss or losses"* he turned to the question of the reinsured's knowledge of the loss; and he concluded:

> *94. "To complete the argument, Mr Sumption says that if RSA [Royal Sun Alliance] does not have knowledge of an actual loss by the third party claimant, then it cannot*

have knowledge that ***such*** *loss may give rise to a claim on the reinsurance. That must follow.*

95. I have concluded that the argument of Mr Sumption is correct. In this case the complainants say that they have suffered loss in that they paid more for the Coca Cola stock than they should have done and so they thereby lost money. If that were a proved fact, then the third party claimants would have suffered an actual loss. But, at the time RSA had received the Complaints, that was not a proved fact. That fact does depend on establishing that the Coca Cola stock would have been at a lower value if the financial position of Coca Cola had been accurately stated to the world during the Class Period. That in turn assumes that the financial position was not accurately stated. It also assumes that the reason for this was the acts, omissions or defaults of the Directors and officers of Coca Cola which were intended to mislead."

17. In the Court of Appeal, the arguments were somewhat different:

12. <u>The submissions</u>

For the Syndicates Lord Grabiner QC sought to withdraw the concession made below that "loss" must be an "actual loss" and submitted:-

(1) the loss referred to in the Claims Control Clause must refer to a "claimed" loss or an "alleged" loss;

(2) if it meant an "actual" loss (as had been conceded before Aikens J), no loss would arise until ascertainment if the loss was Coca-Cola's loss; nor would it be likely to arise at any earlier stage if the loss were the American claimants' loss;

(3) that would be absurd because it would deprive part (b) of the clause of any effective force; there is no point in being advised about a loss after judgment in the American proceedings and it would be futile then (and only then) to have the right to appoint an adjuster or surveyor; it would be too late to control negotiations or even to influence them;

(4) it was only by purposively construing "loss" as a "claimed loss" that the clause as a whole could make sense; it was necessary to adopt this construction since everyone at the time appreciated that what was being reinsured was Coca-Cola's liability and in no other way could the Syndicates (who would ultimately have to foot the bill) be meaningfully involved in proceedings which would determine whether the American claimants were entitled to compensation.

13. Mr Sumption QC submitted:-

(1) "loss" must mean "actual loss"; if the parties had meant or intended it to mean a "claimed loss" or an "alleged loss" it would have been easy to say so; the Syndicates wanted to read into the clause a word that was patently not there; their argument was tantamount to reading the word "loss" as if it had been "claim";

(2) the fact that there was no obligation to notify the Syndicates until RSA knew of an actual loss on the part of the American claimants (or indeed on the part of Coca-Cola) was not of any great moment since it was the duty of RSA and the other members of the Consortium to exercise the rights they had available to them under their own equivalent of the claims control clause and only to make any settlement in a careful and businesslike manner;

(3) the right to appoint adjusters, assessors or surveyors was in any event futile in the context of a liability policy so the Syndicates would not be deprived of anything of value if they were only notified when RSA knew of an actual loss;

(4) RSA had (and still have) no "knowledge" of any "actual" loss on the part of the American complainants;

(5) part (b) of the clause with its reference to the appointment of professionals and the right to control negotiations was, in any event, a powerful pointer to the loss being Coca-Cola's loss rather than that of the American claimants with whom the Syndicates had noting remotely to do; how could the Syndicates in fact control negotiations which would be taking place between the American claimants and Coca-Cola? It might be that RSA could control those negotiations if they had stipulated for a right to do so (in fact they had not), but in practice RSA would, in any event, have to follow the line taken by the majority insurer – here Allianz – in the consortium; on no view could the Syndicates "control" Allianz.

18. The court considered that the arguments on behalf of the reinsurers made sense in the context of a mismatch between a 'claims made' policy [the underlying policy] and the indemnity reinsurance policy:

14. (1) "Alleged" or "actual" loss?

There is no difficulty about Lord Grabiner being entitled to withdraw the concession made below to the effect that "loss" means "actual loss". The first question in the appeal then becomes whether, in its context in the Claims Control Clause in the reinsurance policy, the word "loss" means, as he submits, an "alleged" loss. On one view, there is obvious good sense in so deciding if one knows that the underlying insurance is on a "claims made" basis and requires Coca-Cola to give notice to RSA of any "claim" made against them albeit "as soon as practicable" rather than within 72 hours. It makes even better sense when one appreciates that whoever's loss it is to which the clause refers, RSA may be unlikely to "know" of any actual loss until the loss has been ascertained which will be long after reinsurers would, as the ultimately paying party, wish to be aware of the events which might create their liability."

19. But the Court went on to reject the siren call of trying to make 'business common sense' out of a clause in favour of one party at the expense of the other and pointed out that there was a salutary principle

"*that a party who relies on a clause exempting him from liability can only do so if the words of the clause are clear on a fair construction of the clause, see*

Elderslie Steamship Co Ltd v Borthwick [1905] AC 93, Gordon Alison & Co v Wallsend Slipway and Engineering Co Ltd (1927) 27 Lloyds Rep 285, Photo Production Ltd v Securicor Transport Ltd [1980] AC 827, 850D–851A per Lord Diplock and other cases cited in Chitty, Contracts, 29th ed para. 14-005. In my view the terms of the Claims Control Clause on which the Syndicates rely do not sufficiently clearly exempt them from liability."

20. The Court then turned to consider the question of knowledge:

23. "It is, at this stage, worth pointing out how comparatively unusual the claim is which is brought against the Coca-Cola directors. It is that their conduct caused the share price to be artificially high at the time when the complainants purchased their shares. As the judge points out in paragraph 95 of his judgment, the complainants say that they have paid more for their Coca-Cola stock than they should have done. If that were a proved fact, there would then be an "actual loss" which might give rise to an insurance claim. But when RSA received the complaints, it was not a proved fact; it is a possible conclusion which depends on establishing that Coca-Cola stock would have had a lower value if the financial position of Coca-Cola had been accurately stated. Until this is "known" to be the case, there can be no "knowledge" of any loss.

24. It might well be different if the claim had been that, as a result of something done by the directors of Coca-Cola the value of the stock had fallen; particularly if the stock had been rendered valueless. Then it might be clear that there had been a loss and once RSA were notified of a claim for that loss, it could be said that they then had knowledge of a loss which might give rise to a claim under the reinsurance policy. Lord Grabiner did indeed seek to say that even in the present case there was a loss "known" to RSA because the share price fell from its peak in July 1998 but that cannot of itself be a loss (rather than natural market fluctuation) until it is established that the price was artificially high at the point of purchase.

25. It is, however, quite possible that there will be cases in which (on the supposition that the loss envisaged in the Claims Control Clause is, as the judge held, the loss suffered by the third party claimant) it will be known that there has been a loss which may give rise to a claim, well before a complainant's claim has come to a judgment or a settlement. All one can say is that the present case is not such a case."

21. Since the court accepted that whoever's "*loss*" was being referred to, the reinsureds did not have knowledge of it, the "*whose loss*" issue was not material to the outcome of the appeal, but the court indicated that "*if it had mattered*" it would have reached the same conclusion as the Judge.

22. The differences between the clause in this case and the clause in the *Dornoch* case do not distinguish that from this. The presence or absence of the words "*under this policy*" does not, I think, bear on the question since the claim which the loss may give rise to is a claim under the underlying policy, which may then lead to a claim under the reinsurance policy. The court has interpreted the loss in question as the loss suffered by a claimant vis a vis the insured; the absence of those words would strengthen, rather than weaken that conclusion. There is nothing of significance in the difference in timing of the notifications: "*as soon as is reasonably practicable and in any event within 30 days*" (in the present policy) and "*by cable within 72 hours*".

Finally the co-operation clause in the *Dornoch* case is 'stronger' than in the present case and, therefore, would provide stronger support for the view that the loss was not the loss of the insured but rather of the person claiming against the insured.

23. In my judgment, Mr Foxton was right when he made these submissions in his closing written arguments:

> *"(1) First, the parties chose here a Claims Co-operation Clause ill-suited to the liability reinsurance which they entered into, and which involved a complete mismatch between the claims made Smartforce Policy and the notification of loss required in the reinsurance. Again the mismatch is compounded by the draconian consequences of non-compliance. Again the clause is more suited to a property policy (with its reference to adjustment of the loss) (on all of which see Longmore LJ at para. 10). It is no part of the Court's function to achieve an efficacy for the condition precedent which the language of the clause does not on its face achieve (para. 18).*
>
> *(2 Second, "knowledge is an elusive concept" (para. 30) and not an ideal trigger for a liability reinsurer. However, having chosen "actual knowledge of AIG(I) as the trigger, that is what Faraday must establish. The question whether AIG(I) knew something should be susceptible to a short answer – it is the classic jury question. It is actual knowledge – not constructive knowledge – which is required…*
>
> *(3) Third, the clause is a condition precedent to liability for the losses. In these circumstances, it must be clear to AIG(I) when they have acquired the requisite knowledge to trigger their obligation to notify or lose their claim. This strongly suggests that the identification of what it is that AIG(I) has to know should be a simple and straightforward task, and that it should be possible to point to a readily identifiable event or set of facts to establish such knowledge. When knowledge comes from a judgment making findings of fact, this is straightforward enough. If, however, the argument for knowledge involves an allegation made in developing litigation, the clear and readily identifiable knowledge which the clause requires will be very difficult to find."*

24. It seems to me that one can extract from that case the following points, which are equally applicable here:

> (1) The loss or losses must be the loss or losses of the purchasers of the shares who were the claimants in the class actions in the USA. By a parity of reasoning adopted by Aikens J and the Court of Appeal, to suggest that the loss or losses were of the original insured would render the provisions of (b) of the claims co-operation clause of no effect. By the time the reinsured knew that it had been 'proved' that the insured had sustained a loss, the time for adjustment and settlement would have passed.
>
> (2) The words "loss or losses" are essentially different from 'alleged' or 'claimed' or 'potential' losses. Had the parties intended to use that language they could have done so. It is not for the court to re-write the parties' bargain to remedy a mismatch between insurance and reinsurance cover. Trying to remedy the

mismatch would mean the court taking one side or the other in the commercial dispute. There are inherent difficulties in the concept of a 'potential loss'. Do those words refer to a mere possibility that a loss will eventuate or a likelihood that it will do so? For a clause which has Draconian consequences if not complied with, certainty is required; otherwise it could work capriciously.

(3) A claimant does not suffer a loss unless an actual loss was a "proved fact", which means, in this context, that he had bought the shares at a value which was inflated due to the default of the company's directors and officers in the execution of their duties. The mere fact, if it were proved, that the directors of a company had overstated its financial worth does not inevitably lead to the conclusion that the price paid for the shares prior to correction of the overstatement was a loss caused by that overstatement. A loss can only arise where

> "*it can be established that the price was artificially high at the point of purchase.*" [paragraph 24 of Longmore LJ's judgment].

(4) I reject the submission made by Mr MacDonald Eggers that strictly speaking this case is not binding upon me since it is a decision about a different contract with different wording. Technically, I think he may be right. But the doctrine of *stare decisis* has more to it than the imposition of a requirement that a lower court is bound to follow a higher court's decision. Our system of precedent requires courts to achieve a stable and common approach to legal problems and this is particularly true of commercial disputes where the parties are looking for certainty. Whether the *Dornoch* case is, strictly binding, I would follow its conclusions in any event: not just because they are, I think, correct, but also because stability and consistency 'require' or 'demand' that I should. In the light of this decision I reject the submission that the words *loss or losses* in the Policy, mean *alleged loss or losses*.

(5) There must be a moment in time between what might be called an alleged loss and a known or proved loss, short of a judgment against the insured. Some losses must be known or proved without a judgment because otherwise (b) of the Clause would lose all its efficacy in every case. The task of the court is, I think, to decide when a 'fact' can be said to be 'proved' in this context. This is the real and principal issue in the case.

Factual Background:

25. The share price of Smartforce had fluctuated over the 10 months prior to the announcement that financial statements were to be re-stated. In January 2002, the shares had stood at about US$25. The e-boom bubble burst in about April of that year and immediately prior to the announcement of the restatement the share price was 4.63 and immediately after the announcement the share price fell to 3.07, a fall of 34%. The shares then moved up and down until they were standing at US$5.5 by 17 June 2003. This fall in value in November 2002 was noted by AIG who generated a loss notification document for internal purposes only. AIG had not been contacted by the insured's broker at this time and Mr Jacobs, the officer concerned, based his document upon what he read in the newspapers. Faraday personnel [Mr Hayes] were reading similar things and sent an email to JLT, AIG's brokers, enclosing a document

they had received from an email information service. This fall in the value of the shares was said to have been attributable to the need for a restatement of the financial affairs of the company. The announcement, which may have triggered the fall in the value of the shares, said:

> "*As the Company continues to integrate the businesses of the two merged companies, it has identified three non-core businesses that it originally intended to de-emphasise but that it now intends to exit: Telcom Services, Prokoda Services and Global Services. None of these three businesses is currently profitable and none fits the Company's long-term operating model. Management has decided to exit these businesses and reduce its costs at this time rather than expose the Company to further uncertain revenue opportunities in an uncertain economic environment. This will result in a reduction in expected revenue for the fiscal year ending January 31, 2004 by approximately $30 million, and will more closely align the Company's cost structure with its long-term operating model.*
>
> *In addition, during the integration process, the Company has experienced lower than anticipated renewal rates for customer contracts predominantly in the IT sector. While the Company believes that some of this is a result of the economy, the Company has identified product and platform areas along with customer service and delivery schedule improvements that it believes can improve the renewal rates*".

26. The fact that there was to be a restatement of the financial statements following the merger was not news to AIG or Faraday. AIG's underwriting notes [seen by Faraday] noted that new accounting policies [namely those of Skillsoft] were to be adopted and that this new method of accounting could give rise to changes in the reported earnings, since the date when earnings were 'captured' for accounting purposes was a matter for debate over which there could be room for more than one legitimate view. If at that time, it was suggested that there was a loss within the meaning of the clause then it would be odd that the Policy was extended in the face of such a loss. The plain inference is that at this stage there might have been an anticipated or potential loss but not an actual or proved loss which might hit the policy.

27. The SEC started an investigation and various class actions were commenced in the District Court in the State of New Hampshire. The class was stated to be the shareholders who had bought shares between 18 January 2000 through to 18 November 2002. In a nutshell the claims were that:

> "*Each of the defendants is liable as a participant in a fraudulent scheme … The scheme deceived the investing public regarding the company's business, its finances and the intrinsic value of the company's securities, and caused plaintiff and other members of the class to purchase the company's securities at artificially inflated prices.*"

28. The issues that were identified in the class action included the question whether the market prices of the securities were artificially inflated because of the defendants' conduct and whether the members of the class had sustained damage and if so, what. That case would also involve an assessment of the extent to which any, and if so what,

loss was caused by the restatements and what was caused by the change in the business environment as outlined in the announcement. And, of course, there was still the question whether if the loss was caused by the restatement it was caused by the fraud or incompetence of the directors and officers of Smartforce.

29. There was also an issue as to whether any fall in the value of the shares was attributable to the financial restatements as opposed to the gloomy forecast of future business opportunities. For the purposes of the mediation the experts on the Claimants' behalf, used a figure of 59% as attributable to the financial restatements but there were other analysts who were suggesting that there was no such financial impact. One analyst was of the view that the concerns about the renewal rates and bookings on the Smartforce side of the business being softer in the future, was more important than the restatements of the financial accounts.

30. In March 2003 the various class actions were consolidated by order dated 28 March 2003.

31. On 22 September 2003 the company filed its restatement of accounts with the SEC [Form 8KA]. Such a form is required when there is a material event affecting the company's accounts. The first two preparatory paragraphs of the restatement read:

> "*On 6th September 2002 Smartforce completed a merger in which Skillsoft was judged to be the account acquirer. Following the merger, Smartforce changed its name to Skillsoft Plc. Subsequent to the merger, management of Skillsoft Plc and its advisers raised questions regarding Smartforce's historical financial reporting which resulted in a conclusion that a restatement of certain previously issued financial statements was appropriate. The restated consolidated financial statements for the six months ended June 30th, 2002 and each of the years in the three year period ended December 31st 2001 are the result of a detailed review of the accounting records of Smartforce's previously reported financial statements for the periods of the restatement. The restatement process was supervised by members of Skillsoft's current management team, and outside consultants, who were not employed by Smartforce during the periods discussed. Substantially all of Smartforce's accounting staff during the periods discussed did not remain with Skillsoft when it undertook the restatement analysis and efforts.*
>
> *Smartforce's consolidated financial statements for the period ended June 30th 2002 and each of the years in the three year period ended December 2001 set forth herein differ from its previously reported statements. These differences reduce net income by approximately $127 million and reduced shareholders' equity at January 1st 1999 by approximately $81 million .."*

32. The reason for the restatement of the financial position of Smartforce was stated to be

> *"… the historical financial statements of Skillforce have become the historical financial statements of Smartforce and the assets and liabilities of Smartforce will be accounted for under the purchase method of accounting."*

33. There followed a number of provisions showing that there was to be an alteration to the timing at which revenue can be booked in relation to contracts and the last was a restatement of the reserves for bad debts.

34. If the financial statements of Smartforce had been fraudulent, as the Claimants were alleging, then AIG considered that they might have a good case for rescinding the Policy. They took advice from Irish solicitors, Arthur Cox, on the issue. Their advice on 6 November 2003 was as follows:

> *"As we discussed at our meeting, AIG(I) does not know enough about the awareness within Smartforce of these issues at the relevant time, and nor does it know enough about the reasons for and the process surrounding the restatements. If it is the case that the restatements have come about merely because of the adoption of more conservative accounting policies following the merger, then there may be no issue for Smartforce. It may be noteworthy that Ernst & Young were the auditors to both Skillsoft and Smartforce before the merger and the combined entity afterwards, and it seems that they did conduct the restatement exercise. As they audited Smartforce's financial statements which had to be restated, it would be interesting to know what their position is on the restatement. Were they misled by Smartforce, or is it merely the adoption of a more conservative accounting policy?"*

35. The US attorneys who were looking after coverage issues for AIG made a note following a meeting with the solicitors which stated [10 November 2003]

> *"[Arthur Cox] did not believe that AIG would be able to prevail if it decided to rescind the policy based solely on the company's announced restatement. This is because the reasons cited for the restatement are at least partially as a result of failure to maintain adequate records as opposed to any admitted 'cooking of the books'". [Arthur Cox] believes that an effective defence to any rescission of the policy based on the current state of the record would be that the SmarForce d/s/os were unaware of the potential for a restatement in April 2002 and that the restatement came as a result of a change in accounting philosophy to Skillsoft's more conservative approach."*

36. As is quite normal in actions such as these, the defendants filed notices to dismiss the claims against them. These are dated 2 February 2004. The motions relate to two different claims: the first, and more important, was under the Securities and Exchange Act 1934, the other was under the Securities Act 1933. The claimants fell into two classes, the investors who had bought shares in Smartforce during the class period and before the November restatements. Their claim was brought under the 1934 Act. During the merger process, a number of persons who were shareholders in Smartforce elected to swap their shares for shares in Skillsoft. Their claims were brought under the 1933 Act. The significance of this distinction is as follows: for the latter group,

whose claim lay under the 1933 Act, they were, subject to proving fraud, entitled to claim compensation for the difference between the price they paid for their shares and the value of the shares at the date when the proceedings were bought. As the share price in Skillsoft had increased there was an argument as to whether there was any claim at all for this group and that depended, I think, on whether their claims which were purportedly added as an amendment to existing claims were commenced at the date when formulated or by reference to the date when the original proceedings were commenced. That issue would have had to be resolved had the litigation been fought out.

37. Part of the defence case was that

> *"The restatement, which occurred years after the sales in question, was done at a time when the Company had perfect hindsight about what it would collect. Thus in preparing the restated financial restatements, the Company adopted a new policy: revenue actually collected would be recognized; revenue not collected would be reversed in the quarter originally recognized and netted against the existing bad debt reserves. The fact that the Company subsequently adopted an extraordinarily conservative policy does not suggest the original policy was wrong, much less knowingly so."*

38. It was also suggested that Smartforce had disclosed the accounting policies in the financial statements that had been filed with the SEC and that it disclosed that it was changing its revenue recognition policy; that it had attempted to give due notice to investors and analysts who understood the implications of a switch to a new model.

39. On 12 February 2004, Smartforce's lawyers make a presentation of their case to their insurers. Following this, AIG's coverage lawyer, Mr Kuffler of D'Amato & Lynch, recommended to AIG that they post a reserve for US$7.5 million and this was done for the February 2004 month on 23 February 2004. The AIG note recording the advice they had been given is as follows:

> "*Potential damages could exceed the underlying $15 million limit. Defence counsel have advised that Smartforce will try to settle the claim for remediation in March 2004. Our coverage counsel, D'Amato & Lynch, has recommended a $7.5 million reserve which was posted in February 2004 account month, in the anticipation of a possible settlement*."

40. This reserve of $7.5 million represents a hit against the first layer of the reinsurance cover: in other words, $5 million not reinsured and $2.5 against the first layer.

41. On 2 March 2004, within AIG there was filed a Management Alert Memorandum which referred to the possibility of the claim against Smartforce exceeding the limits of their cover; in other words, leading to a 100% loss under the Policy [with damages exceeding $20 million].

D'Amato & Lynch filed a mediation statement.

42. AIG's tactic for the purposes of the mediation was to stress the point that the better the case against Smartforce in relation to their financial statements, the better the case for the Insurers to obtain rescission of the cover for non-disclosure or fraudulent misrepresentation.

> "*AIG submits this statement in support of its position that the policy should be rescinded and declared void ab initio. AIG will be able to sustain the position that its decision to issue the policy at the premium charged stemmed in large part from the information contained in the financial statements provided by Smartforce in the application for the policy. The subsequent restatement of those financial statements by Smartforce arising from the discovery of financial and accounting errors resulted in significantly increased losses during the periods covered by the financial statements submitted to AIG."*

The Insurers then end their Statement

> "*Notwithstanding the strength of its position, which is likely to increase as discovery and the SEC investigation unfold, AIG recognises that the insureds face significant potential exposure in connection with the underlying lawsuits*."

43. At the mediation which was held on March 23, 2004, Mr Kuffler, on behalf of AIG, said that AIG were prepared to offer $5 million in settlement of the claim under the Policy. At some point during the process, Smartforce indicated that they would not be prepared to accept that offer but were looking for $10 million. Within a week, Mr Kuffler had said to Smartforce's lawyers something along the lines

> "*if we offer $7.5 million is that something you are likely to take?* Transcript, Day 1 page 115, lines 19 -20.

44. What then happened was that a Memorandum of Understanding between the parties to the litigation was prepared and on 25 March 2004, D'Amato & Lynch reported to AIG in Ireland that the case had settled for US$30.5 million without agreement as to insurance recovery and that Smartforce were looking for US$10 million from AIG.

45. It is common ground that Faraday were formally notified of the loss on 19 April 2004. 30 days before that date takes one to 20th March 2004. On these facts, did AIG know of loss or losses sustained by the claimants which might impact on the underlying insurance, before 20 March 2004?

46. In my view the answer to that question is 'No'.

47. The case for Faraday may be summarised thus:

(1) AIG knew of the relevant loss, namely the loss to the shareholders who purchased their shares at a time when the financial statements issued for those periods were inaccurate. Those inaccuracies were revealed when the corrective statement was made on 19 November 2002 and this announcement led to an immediate drop of about 34% of the share value. The effect on the company's accounts was quantified when the corrective statement was made in September 2003 and this showed that the company's net income and shareholders funds had been grossly overstated by tens of hundreds of millions of dollars.

(2) On the evidence of Mr Kuffler, the methodology of calculating the claimants' damages was anticipated by D'Amato & Lynch as early as 2003, namely by reference to the percentage drop in the value of the shares. This was the basis adopted by both the Claimants and by Smartforce who were each putting forward their best case on quantum and it was these figures discussed during the mediation which formed the basis of the settlement. Mr Kuffler accepted that if liability was established then there would be at least some damages to be paid.

(3) The posting of a reserve which 'hit' the first layer of the reinsurance was good evidence of AIG knowing of a substantial loss; the posting of the reserve called for a Management Alert Memorandum highlighting the scale of the loss and AIG's knowledge of it. Smartforce did not suggest in the mediation that there was no loss in relation to the 1934 Act claims. They accepted that some portion of the drop in value was attributed to the restatement. The fact that AIG were prepared to offer US$7.5 million is a recognition of a loss; the only doubts at that time were as to the size of the loss and whether there was coverage.

(4) Looking at the *Dornoch* case, Longmore LJ recognised that the position could be different if

> "*the claim had been that, as a result of something done by the directors of Coca Cola the value of the stock had fallen … Then it might be clear that there had been a loss and once RSA were notified of a claim for that loss, it could be said that they then had knowledge of a loss which might give rise to a claim …*"

This is just the sort of case the Court of Appeal had in mind. Here there was a drop in value of the shares and as prudent insurers AIG were acting accordingly, posting reserves and behaving as they would if aware of a loss. Longmore LJ also said:

> "*It might well be different if the claim had been that, as a result of something done by the directors of Coca Cola the value of the stock had fallen.*"

In this case the errors in the financial statements. for which the directors were responsible, led to a fall in the value of the shares.

48. For AIG, Mr Foxton made the following points:

(1) Faraday's primary case is that AIG's knowledge of the fall in the share price following the press release on November 19 2002 constituted knowledge of a loss. The original reason why Faraday rejected the claim made by AIG was that the clause required notification of 'potential claims'. But it is to be noted that the relevant claim is not: 'my shares were worth $5 before the restatement and I suffered loss because they were only worth $3 after it was made' but rather a more complicated claim that 'my shares were worth less than I paid for them when I acquired them.' The question was whether the market price of the shares was inflated because of the misconduct of Smartforce. The relevant loss, of which AIG must have been aware was the difference between the price paid for the shares and their true market value at the date of acquisition. As Mr Kuffler pointed out, in actions such as these the claimants do not particularise their loss.

> "*It would not be until the expert discovery phase of the case, after all fact discovery has generally been completed where plaintiffs would have to specify their damages*."

(2) A mere fall in the share price does not mean that the claimants have suffered a relevant loss (any more than the subsequent *dramatic* fall in the value of the Coca Cola shares constituted a "*loss*" in the *Dornoch* case). As Aikens J. noted, a relevant loss will only occur if a third party has purchased or acquired shares at an artificially inflated value because the financial position of Smartforce had not been accurately stated at the relevant time and that the reason for this was the acts, omissions and defaults of the directors and officers of Smartforce, or the Company itself. The fall in the value of shares after the announcement was no more than an "*indication*" of an inflation of the share price. As Mr Kuffler said, he did not know whether or not the price of the shares which were bought by the class action claimants were artificially inflated. The fall in the value which occurred on November 19, 2002, had been substantially recovered by December 2002 and fully recovered by June 2003 and by November 2003 were trading at prices well in excess of the pre-statement prices. Further, there remained a doubt as to whether it was the restatement of the shares which was the driving force rather than the bad news about the business forecast.

(3) The proceedings in the USA were settled at a very early stage and well before expert evidence was obtained. There had been no disclosure and no response from Ernst & Young who had audited Smartforce's accounts prior to the merger and who also had audited Skillsoft's accounts. The mediation was not so much a considered appraisal as a horse trade, with the claimants taking about 10% of what they said the claim was worth. There was also an issue as to whether the re-statement was to be expected as a result of different accounting standards being used.

(4) The fact that the Irish lawyers were cautious about the prospect of AIG being entitled to rescind the policy on the grounds that they were misled about the accuracy

of the pre-restatement accounts, demonstrates that AIG did not 'know' of a loss caused by fraud.

(5) During the mediation, it was Mr Kuffler's views that if there was liability then some damages would follow. That was simply accepting that liability and quantum were inextricably linked. There was no acceptance of liability and no acceptance of a loss which might impact the underlying policy. There are documents which show that the claimants' attorneys were well aware of the "*very real risk*" of failure in the litigation. In seeking the court's approval to the settlement, the plaintiffs' attorneys recognised that there would be disputes at a trial "*as to whether revenue was properly recorded under very specific and technical GAAP provisions … as well as causation and damages calculations*" and that the plaintiffs would have to overcome "*the Settling Defendants' argument that the Class suffered no (or, at most, de minimis) damages*" and that "*there is a substantial risk that Lead Plaintiffs would recover considerably less than their full damages or even suffer a defendants' verdict.*" In these circumstances it is clear that at the mediation the question of whether any provable loss had occurred was very much in issue and was one of the 'unknowns' that had to be taken into account in arriving at the settlement.

(6) Mr Foxton then dealt with various documents relied upon by Faraday in the present litigation. In relation to the "Loss Notification" dated 25 November 2002, this represented an initial estimate of a gross loss but does not evidence AIG's knowledge of a loss, let alone a claim. The filing of the re-statement did not show knowledge of a loss on the part of AIG or their representatives. The consolidated claims did not provide evidence of a loss; rather they provided evidence of an alleged loss. At the meeting on 12 February 2004, there was a preliminary damages assessment. Again this is merely an assessment of potential exposure in the litigation; it fell short of showing knowledge of a loss. The same is true of the reserve and the increase in the reserve. An insurance company will make a reserve without knowing whether a 'proved' loss has occurred. It is routine for companies to reserve as a matter of contingency. Further, the offer to settle of $5 million does not show knowledge of a proven loss but rather a willingness to enter into a horse trade. Its willingness to settle certainly shows that AIG knew it had an exposure under the Policy; not that it knew the claimants had suffered a provable loss. The fact that Faraday have been scratching around to find material to support their claim that AIG knew of a loss, shows the weakness of their case. For a clause like the present one to work sensibly and in a commercial manner, the knowledge of the loss must be capable of being specified in terms of time or date. In truth, their case is no more than that AIG knew of the loss once the restatement was announced in November 2002, but that case fails because of *Dornoch* and the logical impossibility in saying that shares must have been bought at an inflated value.

49. Before giving reasons for my rejection of Faraday's case under this head, I should first mention two separate but related points. The first is that AIG knew that plaintiff attorneys' fees had been incurred and this was an item of loss of which AIG had the requisite knowledge. The second argument is that the defence costs constituted a loss of which AIG were aware but were not notified to Faraday timeously.

The claimants' costs

50. The claimants' attorneys were working on a 20% contingency fee basis and they invited the court to rule that they were entitled to take that fee from the total sum of the settlement. The defendant was neutral on the issue. The court granted the request.

51. Mr MacDonald Eggers argues that the plaintiff shareholders claimed their legal fees and expenses in each of the complaints filed. The mere fact that an attorney would not have been able to recover their fees from a plaintiff who failed in their claim does not mean that the Plaintiffs are not incurring legal fees. Those fees or costs are apt to fall within the Claims Co-operation clause. Had the claimants successfully sought to recover their legal costs from Smartforce, AIG would have been entitled to an indemnity under the Reinsurance Policy in respect of them and such costs could have been adjusted or settled; instead the "*Settling Parties have agreed that those fees and expenses will be paid out of the Settlement Fund*".

52. Mr Foxton submits that there is no evidence that the third party claimants incurred any such costs, much less that AIG were aware that such costs had been incurred by the third party claimants. The claimants' costs in bringing a claim are not a "*loss*" for the purposes of the Claims Co-operation Clause. "Loss" contemplates the primary liability of the original insured to provide compensation for loss arising from its wrongful act; not expenses incurred by parties in resolving a dispute about whether such a liability exists. The third party claimants' costs are not matters which can be adjusted or settled by AIG or by Faraday. To construe "loss" to include third party claimants' costs would turn an 'actual loss' clause into a 'potential loss' clause and would be to allow the tail to wag the dog, as it was put by Longmore LJ in *Dornoch.*

Costs incurred on behalf of Smartforce

53. For Faraday the arguments were that defence costs were clearly indemnifiable under the Original Policy, subject to AIG's consent, which must not be unreasonably withheld. By endorsement number 5, Smartforce's costs are indemnifiable in respect of "securities claims" pursuant to that endorsement. Defence costs were included as part of AIG's settlement. The failure to inform Faraday of such defence costs has the result of discharging Faraday from the entire claim because compliance with clause (a) in the claims co-operation clause is a condition precedent to any liability; the settlement with AIG recited that Smartforce had incurred a loss by reason of the defence of the actions and that the claims release extended to "costs". Defence costs formed part of a single "loss" under the Original Policy [with aggregation provisions]. To suggest that a separate notification of costs had to be given in relation to the loss or losses would be absurd.

54. For AIG, Mr Foxton pointed out that defence costs in relation to claims against individual insureds [directors and officers] are included within the definition of "loss" and are subject to the overall limit. Such costs must be incurred with the written approval of the insurer and are advanced on a provisional basis and may be recovered

> "*in the event and to the extent that the company or the insured shall not be entitled to payment of the loss under the terms and conditions of this Policy*".

55. In relation to securities claims defence costs were subject to the US$5 million retention. As a matter of fact there had been no consent by AIG to defence costs.

56. The "loss" referred to in the Claims Co-operation Clause is limited to the "loss or losses" of third party claimants and, therefore, defence costs do not fall within the clause. Second, AIG has never reimbursed any of the Smartforce defendants for any such costs and they are not seeking an indemnity from Faraday in respect of them. It is true that in the Release and Settlement Agreement there were the usual wide words of release, including release from any liability for costs but as Mr Kuffler said in his evidence:

> "*Defence costs (both in relation to the SEC investigations and the class action litigation) were not part of the US$30.5 million class action settlement and when it subsequently settled Smartforce's claim, AIG were clearly only contributing to the amount Smartforce had agreed to pay to the class action plaintiffs. In those circumstances, AIG never paid any element of the legal fees presented to it."*

57. Mr Foxton's submission continued thus:

> "*The alleged failure to notify in time a "loss" which AIG did not pay and for which it does not claim [under the reinsurance policy] cannot provide Faraday with the right to reject a separate claim AIG did pay and notify in time. The condition precedent will only operate in relation to the loss which was not notified*."

58. If Mr MacDonald Eggers were right that a failure to notify a small fraction of the loss caused the whole of the cover to lapse, that would produce a very odd result. Under the original policy, if the insured failed to obtain prior approval to expenditure on costs, that would disentitle him to claim against the Insurer in relation to those costs; it would not give the insurer a right to repudiate liability under the policy. The bill of costs submitted by Smartforce's lawyers amounted to less than $400,000 and bearing in mind the retention, could never have given rise to a claim under the underlying Policy. Knowledge that the costs may give rise to a loss was not good enough. There had been no claim for reimbursement for the defence costs prior to settlement of the Smartforce litigation on 23 March 2004.

Decision

59. Broadly speaking I accept and adopt all of Mr Foxton's arguments, which I will not repeat. On the facts of this case, there never was a loss known to AIG until, at the earliest, 23 March 2004 when a Memorandum of Understanding had been agreed following the mediation. Formal notification was given on 19 April 2004, which is less than 30 days later. At that stage, a 'might be loss' was turned into an actual quantifiable loss for the purposes of the reinsurance. Had there been no settlement then AIG had no knowledge of any loss. The posting of reserves does not establish knowledge of a loss; rather it is the process by which Insurance Companies anticipate the possibility of a loss on a policy. There is an obvious distinction between a "loss" as determined by the Court of Appeal on the one hand, and 'the mere possibility of a loss' on the other. The rise and fall in the value of the shares was not determinative of the plaintiffs' claims; indeed, the subsequent rise in price after the corrective statement was made suggests that the drop in value after the announcement may have been driven more by the business problems than the fact that financial statements were to be restated. Smartforce's accounts were audited by reputable auditors and at the time of the settlement, they had provided no explanation as to why the accounts were to be restated. If the restatement was solely due to the adoption of a new accounting convention, then there would have been no loss. There had been no disclosure, no exchange of expert's reports and no sound basis for concluding that there was any liability or any proved loss. As I have indicated, the settlement was more of a horse trade than a carefully calculated deal, based upon strengths and weaknesses in each party's case. I would have had more sympathy with Faraday if they had sought to argue that Smartforce had no liability, rather than contending that there were losses known to AIG. Of course, their difficulty was that they had agreed to follow the settlements under an appropriate clause. AIG were not committed to paying anything until June 2005, the date of the Release and Settlement Agreement.

60. 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 Insureds for which there was cover under the underlying policy. I do not consider that the loss referred to includes the expenses which the claimants incur in proving their claim. The claimants' costs are not sums which can be adjusted or settled by AIG or Faraday. The construction advanced by Mr MacDonald Eggers would mean, I think, that the word "loss" would mean potential loss, if it were to include the claimants' costs. But in any event, on the facts, the settlement of the claims between the claimants and Smartforce did not include a payment on account of attorney's fees. Finally, no part of these costs would, in any event, have had any impact on AIG under the Policy because of the small sums involved and the high retention [$5 million].

61. As to the defence costs, AIG were never asked to or ever did provide any indemnity in relation to Smartforce's costs. The evidence shows that the settlement figure had nothing to do with those costs which are not part of the Loss for the purposes of this clause.

62. I respectfully agree with Longmore LJ when he said this, at paragraph 21 of his judgment:

> "*Lord Grabiner further pointed out that, unless loss meant an "alleged" loss, there would be a mismatch between the reinsurance of Coca-Cola's liability and the liability for the costs of defending the claim against Coca-Cola. That is because RSA would "know" when they had funded Coca-Cola's defence costs pursuant to the MSP and, if they wanted to recover such costs from reinsurers, they would have to give 72 hours notice of such funding and thus in effect then be giving notice of an alleged claim. Ingeniously as this point was put, considerations of costs cannot influence the primary question of the meaning of "loss". That would be to let the tail wag the dog. It is idle to suppose that if notice of funding were given, notice of loss would not be given at the same time (if it had not been given already). That might mean that reinsurers received notice of a possible loss rather earlier than, on the true construction of the clause, the time when they were entitled to receive it. But that is not a matter of any consequence.*"

63. I refuse to allow the tail of the dog to wag it. These costs were never paid by AIG; no indemnity is being sought in relation to them and this point is raised simply, I think, to try and support the argument that loss means potential loss.

64. The remaining argument raised by Mr MacDonald Eggers was, in my view, hopeless. It goes like this. The requirement in subparagraph (a) of the Clause was to

> "*advise the Reinsurers thereof as soon as is reasonably practicable and in any event within 30 days.*"

65. There are two conditions precedent, each of which must be fulfilled: to advise as soon as is reasonably practicable and to advise within 30 days. Even if the court concluded, as it has, that the loss was notified within 30 days, that is not sufficient if the advice could reasonably practicably have been given sooner.

66. To which I think the answer is:

(1) If that had been the intention behind this draconian clause it should have been spelt out. On a natural reading of the clause a Reinsured would be forgiven for thinking that there was one condition only, namely the 30 day provision and that the other alleged condition was not a condition precedent because the extent of the obligation would be too uncertain to be workable. The words "*and in any event*" destroy the point being made.

(2) The clause would be ambiguous and unfair, if Mr MacDonald Eggers was right. In *George Hunt Cranes Ltd v Scottish Boiler and General Insurance Co Ltd* [2002] Lloyd's Law Reports IR 178 at paragraph 11, Lord Justice Potter, giving the court's judgment, said:

> "*If, as in this case, the wording of the clause is apt to make its intention unambiguously clear, then in my view the absence of the rubric need not be fatal. As with any other contract, the task of construction requires one to construe the policy as a whole. However, in this respect, as it seems to me, if there is a clear expression of intention on the wording of the clause that it shall be treated as a condition precedent, that label or apparent intention cannot simply be ignored. It should at least be regarded as a starting point. I would adopt the further formulation in MacGillivray, 9th Ed, 19-35:*
>
> > *"Such clauses should not be treated as a mere formality which is to be evaded at the cost of a false and unnatural construction of the words used in the policy, but should be construed fairly to give effect to the object for which they were inserted, but at the same time so as to protect the assured from being trapped by obscure or ambiguous phraseology*."
>
> (3) In any event, the notification was given as soon as was reasonably practicable. AIG's lawyers did not receive a copy of the settlement agreement between the claimants and Smartforce until 30 March 2004 at 20.44. On 2 April 2004, AIG asked JLT to notify Faraday of the loss but were told by them that further information was required. Further information was provided that afternoon. On 5 April 2004 [a Monday] AIG's lawyers' report on the mediation [prepared the previous day] was forwarded to JLT and a further letter providing information was also sent to JLT. On 6 April 2004, JLT suggested that yet further information was required and that Faraday would decline liability on the basis of the condition precedent clause. There was then the long Easter break from 9 – 12 April.
>
> (4) Finally, it is not suggested by Faraday that any delay in notification caused them any prejudice.

67. In my view by taking this point, Mr MacDonald Eggers was scraping the bottom of the barrel. It has no merit.

68. The final point in this case is what is known colloquially as the Lumberman's point, based upon the decision of Colman J. in *Lumbermen's Mutual Casualty Co. v Bovis Lend Lease* [2005] 1 Lloyd's Law Reports 494. That case decided that an original insured could not rely on a settlement agreement he had entered into, covering insured and uninsured losses, as establishing a liability for which his liability insurer was obliged to indemnify him, if the settlement sum was not specifically allocated between the insured and uninsured sums.

69. In my view this reported decision has nothing to do with the facts here. I doubt that the decision is right but it cannot, I think, apply to a reinsurance case where there is a follow the settlements clause. As Mr Foxton put it, the decision is "controversial" and was doubted by Aikens J. in *Enterprise Oil Ltd v Strand Insurance Company Ltd* [2006] 1 Lloyd's Law Reports 500 at paragraphs 150 – 173. In my judgment, Aikens J. has correctly identified the flaw in Colman J.'s reasoning which led him to what is an instinctively surprising conclusion. He rejected the idea that extrinsic evidence

could be called to explain the losses and to make the attribution to insured and uninsured items. I do not understand why this is so. I simply say at this stage that I agree with Aikens J's analysis, which produces a commercially sensible conclusion. I would, therefore, not have followed the Lumbermen's case, had I been forced to choose. I am supported in this conclusion by most writers on reinsurance: O'Neill & Wolniecki, The Law of Reinsurance [2nd edition, 1st supplement paragraph 5-45A; Barlow Lyde & Gilbert, Reinsurance Practice and the Law [para 15.2.7.4]; Butler & Merkin, Reinsurance Law [para C-0009/1 and C-0009/2.

70. The settlement agreement in this case did not settle claims which were not insured. Smartforce's insured liability was ascertained in the settlement agreement in an amount which well exceeded insurance limits; a settlement which involved the payment of the insured limits did not include non-insured losses. Smartforce itself had never claimed for expenses incurred in connection with the SEC investigation [which were uninsured] as opposed to the expenses of the individuals in that connection [which were insured]. The fact that the Release & Settlement Agreement included a release from all claims relating to the SEC investigation does not provide any support for the theory that uninsured losses were being compromised. In any event, Faraday are bound to follow the settlement and have not advanced a case that it was not a proper and business like arrangement.

71. In short, the Lumberman's point is a bad one because the decision which established it is, in my respectful view, unsound and should not be followed. The facts do not allow the point to be maintained in this case. In every case it is simply a matter of evidence to establish what the insured losses were; and the court should receive such evidence as the parties wish to advance on the question, without any preconceived notions of admissibility.

72. It follows, therefore, that I regard the claim in this case as well founded and the claimants are entitled to judgment.