



LANDMARK DECISION: LMX spiral losses recoverable on the basis of actuarial modelling

Equitas Limited v R&Q Reinsurance Company (UK) Limited and Equitas Limited v ACE European Group Limited

Commercial Court – 11 November 2009

Facts

The Defendants (collectively R&Q) reinsured Lloyd's Syndicates (who assigned their rights to the Claimant, Equitas) under various contracts of retrocessional excess of loss (XL) reinsurance within the London Market Excess of Loss (LMX) spiral.

The 26 reinsurance contracts in question all incorporated the Joint Excess Loss Committee Excess Loss Clauses (the JELC Clauses) which provided at clause 1.3:

"1. REINSURANCE CLAUSE

1.3 It is a condition precedent to liability under this contract that settlement by the reassured shall be in accordance with the terms and conditions of the original policies or contracts".

Issue

The case concerned the question of whether, due to the fact that the LMX market initially incorrectly (i) aggregated certain losses; and (ii) included irrecoverable losses, Equitas was now unable to recover under the reinsurance contracts for otherwise (potentially) recoverable losses thus 'tainted', in circumstances where it was impossible to replicate the LMX spiral at each level without the introduction of the erroneously aggregated and irrecoverable elements.

Background

The initial wrongful aggregation and allowance of irrecoverable claims in the LMX market arose out of two catastrophic losses – (i) the oil spillage from the 'Exxon Valdez' in 1989, and (ii) the losses of a fleet of aircraft owned by Kuwait Airways Corporation (KAC) and a British Airways (BA) aircraft in 1990/1991.

14 of the 26 reinsurance contracts at issue were said to be 'tainted' by the wrongful KAC/BA aggregation and 12 by the erroneous allowance of irrecoverable Exxon losses.

The Arguments

Equitas asserted that its recoverable losses were capable of being proven, using the best evidence available in the circumstances. This was an evidential question of fact, not a question of law. It submitted that it had quantified its losses on the balance of probabilities with the aid of actuarial modelling. Such modelling effectively allowed suitable discounts to strip out the wrongly aggregated or irrecoverable elements, thus leaving a minimum recoverable amount properly due under each reinsurance contract.

R&Q's defence was that Equitas was not entitled to recover anything. They argued that, in accordance with Lord Mustill's judgment in *Hill v M&G*, and in order to satisfy clause 1.3, Equitas was required to demonstrate, on a contract by contract basis, how properly aggregated and recoverable losses would flow upwards through the spiral. As a matter of principle, they could not do this

by way of a generalised actuarial model which did not exactly reconstruct the LMX spiral. Furthermore, the model utilised by Equitas was flawed.

Equitas responded that it could not, and was not, seeking to recover for erroneously aggregated or irrecoverable losses. However, as regards the recoverable elements of the losses, it argued that it was not required to undergo a process of regression involving establishment of its loss at every underlying stage of the spiral. It was wrong of R&Q to assert that even otherwise wholly recoverable claims must fail, because of initial 'tainting' affecting only a small proportion of the losses, or arising only at a late stage by when a very significant percentage of allowable loss had already been incurred.

Decision

The Commercial Court held in favour of Equitas, concluding that its claims should not fail as a result of its inability to reconstruct the LMX spiral.

Gross J was of the view that the judgment in *Hill v M&G* was not authority for the proposition that Lord Mustill's first rule (ie that a reinsurer is only liable if the loss falls within the cover of the policy reinsured and within the cover created by the reinsurance) could only be satisfied if Equitas could re-present correctly aggregated losses throughout the spiral. Lord Mustill did not state this expressly in his judgment. The reference in clause 1.3 to the "original policies or contracts" must relate to the inwards policies or contracts, and not to the intermediate or underlying contracts.

Further, there was a real distinction between asserting that the loss must fall within the cover of the inwards policy, and then requiring proof of liability under each and every underlying contract. It was illogical to assert that because a claim may have been paid out at some much lower level of the spiral with the cover furnished at that level, it necessarily followed that a settlement at a higher level could not satisfy Lord Mustill's first rule.

Gross J considered that the key distinction was between questions of law on the one hand, and questions of fact or evidence on the other. Equitas was required to satisfy Lord Mustill's first rule, as a matter of law, to the standard of the balance of probabilities. However, neither

the judgment in *Hill v M&G*, nor clause 1.3, stated how this was to be proven.

Accordingly, once it could be shown that an Equitas liability did, on a balance of probabilities, prima facie fall within the cover of the policy reinsured (for example, because the applicable excess had been exceeded), liability would be proven. At that stage, the Court must assess quantum based on the available evidence. There was no difficulty in principle with Equitas seeking a recovery in a minimum amount, provided that the minimum amount was proven on the balance of probabilities; the consequence was merely that Equitas would relinquish any attempt to recover additional sums. The extent of losses, once liability had been proven, need not be established with scientific exactitude.

Furthermore, Gross J was of the view that the actuarial models, although complex, expensive and imperfect, provided an acceptable route to proving the properly recoverable losses incurred by the Syndicates.

Comment

If the decision stands and is not appealed, or is upheld on appeal, it potentially opens the way for millions of losses to start flowing through the LMX spiral. On the other hand, given the Judge's detailed analysis of the decision in *Hill v M&G*, which has stood for many years as the bible on the meaning of a loss settlements clause, there must now be at least a risk that the appellate courts will undermine it.

The decision is helpful, as whilst not authoritatively deciding the point, it provides some useful guidance as to where the burden of proof lies in establishing that the provisos have been satisfied. It remains to be seen whether the decision will open the door for the use of actuarial modelling to recover other categories of losses.

If you require any further information in relation to the way in which these developments impact upon your business please contact Nicholas Bradley, David Breslin or Susannah Fink on 020 7379 0000 at Lawrence Graham LLP

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