



Client Alert

7 December 2009

Unravelling The LMX Spiral?

The LMX market will be considering the recent judgment handed down in *Equitas Ltd v R&Q Reinsurance Co (UK) Ltd* [2009] EWHC 2787 (Comm) closely to ascertain precisely to what extent cedants can use Equitas's complex actuarial modelling technique to unravel their own spiral claims and move the market out of what the Judge described as the "lockdown" which has plagued it for years.

Background

In this case, Equitas, as assignee of the rights of Lloyd's Syndicates, sought to recover losses sustained under contracts of retrocessional excess of loss reinsurance written by the defendants within the London Market Excess of Loss (LMX) spiral. The losses had arisen as a result of claims made in respect of the 'Exxon Valdez' oil spillage in 1989, and the loss of aircrafts by British Airways ("BA") and Kuwait Airways Corporation ("KAC") following the Gulf War in 1990. The action concerned 26 retrocessional level excess of loss contracts with limits of cover excess of a stipulated amount, or attachment point, on an "each and every loss" basis and by reference to the syndicate ultimate net loss. 14 of the 26 reinsurance contracts at issue were said to be "tainted" by incorrect aggregation of cover by KAC/BA aggregation and 12 by erroneous allowance of irrecoverable Exxon losses.

All the reinsurance contracts incorporated the JELC clauses which state that "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". Many of the reinsurance contracts also provided that the loss settlements of the reinsured would be binding on the reinsurers provided those settlements were within the terms and conditions of both the original policies and the reinsurance contracts.

Issues

The key issue was the question of whether, due to the fact that the LMX market initially incorrectly aggregated certain losses and included irrecoverable losses in their loss presentations to reinsurers, Equitas was now unable to recover under the reinsurance contracts for otherwise potentially recoverable losses in circumstances where it was impossible to replicate the LMX spiral at each level without the introduction of the erroneously aggregated and irrecoverable elements.

Equitas asserted that its recoverable losses were capable of being proven, using the best evidence available in the circumstances. Equitas further asserted that the use of actuarial modelling effectively allowed suitable discounts to strip out the wrongly aggregated or irrecoverable elements, leaving a minimum recoverable amount properly due under each reinsurance contract.

R&Q's case, as reinsurers against whom recovery was sought, was that Equitas was entitled to recover nothing at all. They argued that unless Equitas could prove, on a contract by contract basis, how properly aggregated and recoverable losses would flow upwards through the spiral, the losses must lie where they fall. In principle, the losses of individual syndicates cannot be proved by a generalised actuarial model and further, the Equitas model itself is flawed and does not achieve this purpose.

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.

Mr Justice Gross was of the view that the judgement in (*Hill v Mercantile and General Reinsurance Co PLC* [1996]) would not bind the court to conclude that Equitas could not succeed unless it could represent

correctly aggregated losses upward through the spiral. He went further to say that while Equitas had to show, on a balance of probabilities, that the settlements were within the terms and conditions of both the syndicate's inwards and outwards contracts, there was nothing in the Hill case as to how it had to do that.

Mr Justice Gross considered that the key distinction was between questions of law on the one hand, and questions of fact or evidence on the other.

The judge found that the prior practice in the LMX market of not actually requiring a strict proof of loss at every stage of the contractual chain for pragmatic reasons supported his conclusion that there was no reason to require Equitas to satisfy this burden now.

Equitas was able as a matter of law to show that the recoverable losses fell within the scope of the cover provided by its inwards and outwards contracts and that the attachment levels of the R & Q excess of loss reinsurance had been breached. In those circumstances, Equitas was free to prove the amount of its claimed loss in any way it liked. The Judge agreed with Equitas that there is no need for a cedant to prove its actual full extent of its recoverable loss if it was prepared to accept, and could prove, its loss in some lesser minimum amount.

Actuarial models

Equitas sought to utilise actuarial modelling to prove its claim.

R&Q objected to this approach. R&Q submitted that the models were incapable of discharging the burden of proof resting on Equitas. R&Q further submitted that the question was not whether the models were "reasonable" but whether they proved that individual attachment points had been reached.

Equitas, on the other hand, conceded that it was correct that the models did not seek to recreate the actual spiral, but that did not matter because the model provided a reasonable representation of the relevant features of the spiral for the purposes which mattered.

Mr Justice Gross considered the question to be whether the modelled output permitted conclusions to be drawn, with confidence and to the requisite standard of proof, as to the recoverable losses for each syndicate. On a balance of probabilities, the models employed by Equitas did that and provided answers that were representative of the actual position.

Furthermore, Mr Justice Gross 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.

Impact for the insurance market

This decision could have far reaching effects as LMX participants have been waiting for a decisive ruling. The decision opens the way for cedants to re-present significant losses to their reinsurers which have for years been paralysed in the LMX spiral, so long as they can come up with a reasonable evidential basis for proving what their recoverable losses are. It is not necessary for them to reconstruct the exact features of the spiral to prove their recoverable losses - a task which all parties and the Court accepted was impossible.

The judgment is also of wider interest to the reinsurance market. The judge clarified that where a reinsurance contract contains a follow settlements clause requiring a cedant to prove that a claimed loss fell within both his direct policy and outwards reinsurance before he can recover from reinsurers, it is not legally necessary for him also to prove the loss under each and every excess of loss contract in the underlying reinsurance chain.

This means that a settlement which may have been made much lower down the reinsurance chain outside the cover provided at that stage will not, in itself, prevent a cedant higher up the spiral from succeeding against his outwards reinsurer, so long as the loss presented falls within the cedant's own inwards and outwards contracts.

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