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Insurance and Reinsurance Newsflash

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Equitas v Randall & Quilter and Equitas v ACE European Group Limited

Judgment of Mr Justice Gross of 11 November 2009 in the Commercial Court, Queen's Bench Division of the High Court. (Click [here](#) to see judgment in full on [baillii.org](#))

Origin of species: spirals

"Spirals" exist, rather like mini-tornados, in all financial markets. They seem to come along, like *El Nino* years, in batches, create havoc in their markets, and then subside, as if by magic. Some can be collapsed; some just spin out the top and take a couple of innocent capacity players with them. Some are less easy to shift.

There is a really ugly one sitting off the Bank of England at the moment - in the form of the Credit Default Swaps market - but that's another story, and another spiral, for another day.

They are not, despite some commentators' views, a uniquely American phenomenon; likewise, it is said by real meteorologists that tornados are actually more common in the UK than the USA.

They can be "small, tight and closed", or "large, languid and leaky". They can involve small numbers of players, or many.

The LMX Spiral

The LMX Spiral of the late 1980s is one of the biggies, a veritable market phenomenon, impenetrable, arcane, and fascinating to economists, regulators, lawyers and reinsurers in equal measure.

Its analysis as a matter of legal interpretation can be found in the judgment of Phillips J., as he then was, in a case name redolent of the characters who epitomised the good, the bad and the ugly of the LMX market: *Deeny v Gooda Walker* [1994] CLC 1224 at pp 1231-1232.

The judgment is a rather more useful analysis than the Walker Report which failed to find anything wrong with it.

Whatever its origins and whoever contributed to its genesis and maintenance, it cannot be ignored. It has caused the downfall of hundreds of enterprises. It earned certain well-known brokers absolute fortunes in brokerage. It has cost many Lloyd's names their last pennies, set of cuff-links, livelihood, and in some cases, more than that. It contributed to the demise and near failure of Lloyd's "1992 and prior" years.

It is ironic therefore, that the escape vehicle that allowed Lloyd's to revive, phoenix-like, from the rubble of the late 20th century London Market - Equitas - should be the instrument to unlock the residual obligations of the LMX spiral at the end of the "noughties".

And the findings of the judge in a case which seeks to address the spiral phenomenon head on will attract much market interest.

LMX Spiral in crisis

The LMX Spiral has been in virtual lock-down, frozen and immobile, save for the odd commutation, for years. Two catastrophes in particular caused it to seize: *Exxon Valdez* (89G), and *Kuwait Airways* (90V).

In the beginning, both losses entered the market in the ordinary way. Neither



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was particularly unusual, in the sense that, unlike the latent APH claims market which was the other hand that strangled the old Lloyd's, these sort of claims were really rather standard fare for the London Market. Big, identifiable, immediate, and high profile classic aviation and marine claims.

Their considerable size, however, was swiftly magnified by the spiral, just as *Piper Alpha* and the *October Hurricane* had done some 3 years previously.

Claims of well under half a billion dollars on the direct insurance side on each loss "spiralled" to produce two monster losses, each of over \$6 bio, for the LMX market.

Two sets of coverage cases then established that on one claim (Exxon) part of the settlement should not have been paid; on the other (KAC) part of the claim fell in a different year and thus formed a separate claim. So there had been a wrong aggregation, and a payment of uncovered losses, both of which, significant in their own right, were then themselves magnified by the working of the eternally revolving spiral.

In *Exxon Valdez*, two cases (*CU v NRGV* (1998 2 Lloyd's Rep 600, and *King v Brandywine* [2005]EWCA 235) had established that part of the original settlement was not actually covered by the insurance contract, and so was not recoverable from reinsurers.

In *KAC*, another court (*Scott v Copenhagen Re* [2003] Lloyd's Rep IR 696) had established that loss of a BA aircraft to "friendly fire" in February 1991 could not be aggregated with the original loss of 15 Kuwait Airways aircraft in the August 1990 Gulf War invasion of Kuwait.

The claims closings that had occurred by the time those coverage decisions were made had irretrievably entangled the constituent elements of the inwards claims, such that an impenetrable Gordian knot of now "tainted" claims had worked its way up into the heart of the spiral.

Those further up the spiral cried "Halt"! Those below pressed for payment, but could not prove their loss on an each and every contract basis.

Reinsurers progressively declined to accept retrocessional claims that (they said) were "tainted" by the inclusion within the constituent loss transactions of indeterminate - and indeterminate - slices of the wrongfully aggregated or incorrectly covered elements from the underlying losses.

Reinsurers had also been encouraged by dicta of Lord Mustill in the House of Lords in *Hill v M&G Re*, which (in [1996] 1 WLR 1239{HL}) had turned down an application for *summary judgment* on reinsured Kuwait Airways losses, based on disputed issues of aggregation and a slightly different set of hypothesised facts than those which eventually came to be regarded as settled within the market.

Deadlock followed. Market initiatives failed to unlock it.

Finally, this test case was mounted.

Equitas v R&Q; Equitas v Ace European Group

Equitas paid an actuary a small fortune to model the claims in order to "prove" that reinsurers on a sample of 26 contracts were bound to pay. 14 contracts contained KAC losses. The other 12 concerned Exxon.

Reinsurers said that Equitas was precluded from showing - as a matter of **law** - the necessary level of certainty and accuracy of claims to require reinsurers to "follow" the settlements pursuant to clauses in the JELC form and containing the so-called "*double provisos*" which had doomed the claims in *Hill*.

The reinsurers said that no amount of actuarial modelling could cure the reinsureds' inability to show, contract by contract, their UNL.

The spiral could not be replicated. The claims must be proven properly, or fail entirely.

The judge held that there was **no rule of law** that prevented the reinsureds from making out their claims.

It was all a matter of **evidence**.

"Follow settlements" clauses did not specify how losses should be evidenced.

Even if evidence was poor, it was nevertheless capable of proving **on a balance of probabilities** that coverage existed.

Although it was theoretically **possible** that one or more of the claimant syndicates would somehow have escaped paying more in UNL than the requisite excess point for each of the two catastrophes, because **all** of their inwards claims had been of the "tainted" and invalid variety, the **probability** was that they had not.

If therefore the reinsureds could show simply on a **balance of probabilities** that they had suffered losses of a magnitude that breached the excess points of the 26 xol contracts under review, it mattered not that they were unable to unpick the tangled thousands of claims transactions that went to make up the aggregate claim to show exactly what they had paid in each transaction.

And if, as the parties both averred or acknowledged, a contract by contract review of claims was out of the question, given the thousands of transactions involved, then Equitas' expert actuarial model, suitably crafted, was, even though it might be "*complex, expensive, imperfect and...not ideal*", an aid to "*doing practical justice - a solution emphatically preferable to leaving the losses to lie crudely where they fall.*"

Although subject to heavy criticism from reinsurers and their own actuary, the models, which contained discounts of varying degrees were "*an acceptable, soundly based route to establishing the properly recoverable minimum losses...having regard to the applicable burden and standard of proof.*"

Comment and wider implications

- The case illustrates the dangers and difficulties of relying on dicta in a case of summary judgment (*Hill v M&G Re*) to seek to establish rules of law applicable to every situation.

Lord Mustill's comments in *Hill v M&G Re* did not enable reinsurers to convert the *dicta* "*from the general to the particular*" and apply them slavishly to the facts of this case.

Equitas' actuarial model, on the other hand, courtesy of its conservative assumptions and discounting, could.

- The case also highlights the distinction between an inability to tell, for example, which of two defendants did a bad act (which would allow both of them to walk free) from an inability to distinguish between parts of an intertwined claim scenario. We have seen how the courts had to tie themselves in knots - and ultimately be saved by the legislature on mesothelioma cases. The underlying rule remains, that if you cannot tell, say, which of two parents murdered a child, neither can be convicted of the capital crime. If you cannot tell which of a dozen shippers introduced rats to a vessel, all of them escape liability. That rule stays.
- The value of actuaries and the importance of their instructing lawyers testing out their evidence by detailed interview rather than leaving it to cross-examination is here demonstrated in an object lesson in expert witness preparation. At least this was not your typical Commercial Court case, where **both** sides end up relying on the **opponent's** expert's evidence given under cross-examination!
- For arbitration cases, the emphasis in this judgment on *evidence* rather than *law* in the fixing of the level of recovery once liability in principle is established gives even greater power to intelligent arbitrators to convert points that may be subtly and persuasively advanced as points of law - and thus (possibly) appealable - into what the judge referred to as "*jury points*" that are exclusively for the arbitrators to determine.
- There are some helpful remarks in the judgment (paras 73-85) about the utility of "*collection notes*" rather than hard-core underlying evidence, and "*strict proof of loss*" as potentially adequate proof within the London Market. This may by a side wind enhance considerably the utility and value of the **ARCF** reporting process for APH claims.
- Finally, the question arises of whether this "pat on the head" for actuarial evidence might make it easier to recover so-called "pure IBNR" losses settled as part of a commutation from reinsurers.

On that point, the "*jury*" may not have a say; most defences denying the recoverability of IBNR rely on arguments as to whether commutations are in themselves "*loss settlements*" (cf. *Hiscox v Outhwaite*), rather than on attacking the accuracy of the actuarial calculations.

That point remains up for grabs.

But the eternal pendulum swinging between reinsurer and reinsured seems to have slid back in favour of the reinsured, albeit after a great deal of cost and expertise from the actuarial fraternity to help the reinsured along.

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