REINVENTING THE SPIRAL

A recent court ruling in Equitas v. Randall & Quilter aims to rectify a situation whereby loss claimants are systematically stymied in their attempts to make reinsurance recoveries. Alexander Jenkins reports.

Expectations have been raised that a recent decision of the London Commercial Court will be the key to unlocking billions in unpaid claims that have been clogging the London Market Excess of Loss (LMX) spiral for two decades. Although the decision is unique to the legacy of the tight reinsurance spirals created in London's past, the judge's explanation of the nature of the burden that a cedant must satisfy to prove its claims, and his willingness to consider alternative forms of evidence to satisfy that legal burden, gives the decision significance beyond the spiral's arms.

The case concerns two loss events: the 1990 Gulf War Kuwait Airways hull losses and the property and casualty (marine and public/third-party liability) losses from the 1989 Exxon Valdez grounding. The two losses entered the spiral some 20 years ago. The spiral 'turned' for a few years while participants were billed for and then paid these claims, and then recovered their losses from their retrocessionaires (which were also spiral participants). As doubts surfaced some years later about the initial market treatment and payment of these two loss events, claims *moratoria* were established pending clarity.

Two coverage decisions confirmed these doubts—that the Kuwait and Exxon loss events were constituted with 'tainted' elements:

- In *Scott v. Copenhagen Re Co (UK) Ltd* [2003], the court determined that the market's aggregation of Kuwait Airways and British Airways losses into one loss event (event code CAT 90V) had been wrong
- In *King v. Brandywine Reinsurance Co.* [2005], the court held that the Exxon (event code CAT 89G) loss event contained uninsured losses. The direct insurance loss settlement had been wrong to pay for certain heads of loss.

These court decisions confirmed that the market had been right to eventually refuse payment of these loss events—as they were constituted with unrecoverable losses. These decisions did not provide guidance, however, as to what to do next. Participants could not undo the spiral and were stymied from moving the spiral forward. The market provided no internal solution, hence this litigation.

OPACITY AND COMPLEXITY OF THE LATE 1980s/EARLY 1990s LMX SPIRAL

The LMX spiral arose when excess of loss (XL) reinsurers within the London market extensively subscribed to lines of another market participant's whole account, on an XL basis—known as 'XL on XL' or 'Hard XL'. This led to illusory loss transfer, causing a concentration of risk among the same group of LMX 'players'/participants. This trading was opaque too. A purchaser of reinsurance could assume a large segment of its own retroceded book of business (reinsured only a matter of degrees away). It made monitoring aggregate exposures difficult, if not impossible.

The contracts typically responded on a 'per event' basis, which caused the loss events to be 'magnified'. For example, each time a participant was billed for the Kuwait CAT90V loss event, the bill was stacked onto the previously billed figure. As brokers turned the spiral—presenting periodic claims collection notes to each reinsurer—the losses appeared to grow in size. The magnified losses hit ever-higher XL layers due to this accounting treatment, rather than actual loss deterioration. This continued until the losses were 'leaked' out of the spiral—for example, from retention levels absorbing the losses and/or cessions to non-spiral participants such as foreign reinsurance markets and/or exhaustion of participants' reinsurance protections preventing the loss to circulate further.

The effect on the Kuwait and Exxon losses was forensically dramatic. The judge recorded the evidence of an expert actuary, commenting on the Kuwait loss and the number of transactions and participants involved, as follows:

"The original direct loss was round about $343 million, excluding the spares loss. By 1996, say, that figure had increased to $6 billion, so the spiral had turned on average nearly 20 times. And I think it is worth considering what happens on each turn of the spiral. What happens is that a loss is passed on by a cedant to its reinsurers. Typically, a reinsurer will have 25 separate companies participating on the outwards reinsurance contract. So in the first turn of the spiral, a portion of direct loss is split 25 times. Take one of those 25 components. It is amalgamated with other small portions of loss and then passed on to another reinsurer, and it is split a further 25 times. And a further 25 times. The process continues through each turn of the spiral. So what happens is that the Kuwait and the BA losses are divided into what would seem to be microscopic portions or components by the time the spiral has turned nearly 20 times, and the spiral UNL [ultimate net loss] for Kuwait is $6 billion."

Reversing the spiral was impossible. The number of front-end involvements circulating made this too difficult (even if records of all spiral transactions had been kept). Several participants had commuted their obligations too, thus exiting the spiral for good. Progressing the spiral forward, on the basis that past settlements had been at the least 'honest, proper and businesslike', was not practicable. The burdensome terms and conditions of the XL policies—the market had generally traded using the Joint Excess Loss Committee Excess Loss Clauses (JELC)—provided a near watertight reinsurance coverage defence (see below).

It is this mix of difficulties that caused the spiral to enter 'lockdown' and that led Equitas—using its unique position as assignee of the rights of 1992 and prior Lloyd's years of account—to accept, on the one hand, that it could not recover for unrecoverable Kuwait and Exxon losses, but to pursue recovery from Randall & Quilter (R&Q), using unorthodox methods for 'reinventing the spiral'.

EQUITAS V. R&Q

On this arm of the spiral, R&Q reinsured the Equitas syndicates.

R&Q put Equitas to proof of its losses, under the JELC policy language. It required Equitas to present its Kuwait and Exxon claims, with supporting data, demonstrating its recoverable losses passing upward through each underlying spiral contract with the unrecoverable elements stripped out—thereby demonstrating to R&Q that Equitas's ultimate net loss (UNL) had exceeded the attachment points of R&Q's layers. R&Q also required Equitas to apply compensatory payments made to entry spiral participants by the United Nations—which would arguably decrease Equitas's UNL. Until then, R&Q argued, Equitas was not entitled to indemnity.

R&Q did not dispute that the losses, if presented stripped of their unrecoverable elements as breaching the applicable attachment points, were covered by its 26 XL JELC policies. R&Q's chief coverage defence relied on the following clause regarding reinsurance:

"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."

In addition to the above JELC clause, the following (and similar in effect) Settlements Clause, which had been the subject of a 1996 House of Lords

"There are only two rules, both obvious. First, that the reinsurer cannot be held liable unless the loss falls within the cover of the policy reinsured and within the cover created by the reinsurance. Second, that the parties are free to agree on ways of proving these requirements." Lord Mustill, Hill v. M&G [1996].

(now the Supreme Court) decision concerning the Kuwait losses, *Hill v. Mercantile & General (Hill v. M&G)*, stated:

"All loss settlements by the Reassured including compromise settlements and the establishment of Funds for the settlement of losses shall be binding upon the Reinsurers, providing such settlements are within the terms and conditions of the original policies and/or contracts...and within the terms and conditions of this Reinsurance."

R&Q relied on the Hill v. M&G decision for legal precedent. Lord Justice Mustill had stated memorably that the above clause contained the following provisos for recovery:

"There are only two rules, both obvious. First, that the reinsurer cannot be held liable unless the loss falls within the cover of the policy reinsured and within the cover created by the reinsurance. Second, that the parties are free to agree on ways of proving these requirements."

Equitas's burden at law seemed clear from this, but it was noted that Lord Mustill had not explained *how* a cedant "must prove what it must prove"—particularly under the "original" contracts.

Equitas spent considerable effort producing actuarial models of the spiral to prove a minimum recoverable amount from R&Q, including the extraction of the unrecoverable losses. R&Q criticised this mathematical centrifuge for a number of reasons, including for failing to address commutations between spiral participants, insisting that Equitas could only prove its amended UNL the hard way.

Mr Justice Gross heard supporting evidence not only from the actuaries who created Equitas's model, but also from past doyens of the LMX market as to how claims had been paid in the past—as it seemed that the above clauses would otherwise invite the spiral to choke itself "under a sea of enquiry" each time a loss was presented within it. From this, he reached the following conclusions, holding in favour of Equitas:

1. The focus of whether the Kuwait/Exxon losses are within the terms of the "original policies and/or contracts" was not an enquiry of liability under each spiral JELC policy from the spiral's ground-up, but was on the immediate ceded reinsurances directly beneath/inward to Equitas.
2. The judge found some support for his conclusion from market experts. The market had operated on "mutual trust"—until the claims *moratoria*. Payments were made on the basis of 'collection notes' only, which had acted as sole proof of loss. The LMX market itself was the "universal background" to the losses.
3. Lord Justice Mustill's provisos in Hill v. M&G had created a clear legal requirement but had left open how a cedant could achieve it. It was open to Equitas to use the best evidence available to it—here, the actuarial model—to prove its UNL on the balance of probabilities.
4. Despite a number of criticisms that R&Q had made of the models (the judge's impressive consideration of the models, their source data and these criticisms consumed two-thirds of the judgment), the judge was satisfied that they made the connection "from the general to the particular". On the balance of probabilities, the model showed Equitas's UNL to breach the excess points of the 26 R&Q XL contracts.

Subsequent to the decision, the parties reached a settlement and commutation of the outstanding disputed sums—and no appeal was filed (as had been anticipated). The judge hoped his judgment would kick-start the spiral. It may do. Equitas, at least, is likely to present modelled UNL and press for recovery from its other retrocessionaires, who themselves might build their own models or seek to use Equitas's source data.

If the spiral was so 'kick-started', a number of interesting intra-participant arguments might be run:

- Should participants ascertain the level of their past overpayments of irrecoverable claims, it may be feasible to seek their recovery for 'mistake of law' (see the House of Lords decision in *Kleinwort Benson Ltd v. Lincoln City Council Kleinwort* [1999]). R&Q did have a similar counterclaim against Equitas but chose not to plead it. There would be defences to such a claim and past commutations are likely to preclude against mistakes of law.
- The House of Lords ruling in the case of *Sempra Metals Ltd v. Revenue & Anor* [2007] may permit cedants to claim compound interest from recalcitrant reinsurers for the delayed payment (as opposed to just simple interest) from the date the reinsurance cause of action accrued until payment (unless interest accrual was stood still).
- The House of Lords decision of *Wasa v. Lexington* [2009] may have caused the participants' cause of action against each other to have accrued much earlier than the previous orthodox view would suggest, and may have become time-barred prior to the relevant market standstills being effected.

The judge's analysis of the JELC provisos concerning "original contracts" is not limited to spiral reinsurance or adducing actuarial models to prove loss. The judge's reasoning toward actuarial data could apply to retro-recoveries of opaque market losses, where they are made up of many loss involvements, of which the retrocedant has little knowledge. Recovering commuted OSLR (outstanding loss reserves)/IBNR (incurred but not reported) balances, which are not within the common definition of 'loss settlements', will not likely be assisted by this decision. □

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Further information about *Equitas Ltd v. R&Q Reinsurance Company (UK) Ltd* [2009] EWHC 2787 is available at: www.bailii.org