# UNWINDING THE SPIRAL:
# HOW ENGLISH COURTS INTERPRET "FOLLOW THE SETTLEMENTS" CLAUSES

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The London Market Excess of Loss spiral (the 'LMX' spiral) is a phenomenon which has caused repeated systematic collapses in the reinsurance market over the past two decades. In recent years, several arbitrations, involving thousands of LMX spiral-related claims, were put on hold pending the outcome of the case *Equitas Limited v. R&Q Reinsurance Company (UK) Limited, and Equitas Limited v. ACE European Group Limited* [2009] All ER (D) 154 (Nov).

In November 2009, the Commercial Court judge Mr. Justice Gross ruled that Equitas was entitled to recover reinsurance losses based on actuarial (statistical) modelling. This judgment sets an important legal precedent concerning the role of quantitative risk analysis, by stating that the actuarial model employed by Equitas - despite being *"complex, expensive, imperfect"* - constitutes *"an acceptable, soundly based route to establishing the properly recoverable minimum losses sustained by the syndicates, having regard to the applicable burden and standard of proof"*.

The ruling makes an important contribution to the ongoing discussion as to the circumstances under which a reinsurer is required to pay upon a loss settled by its reinsured. The judgment is also one of the first cases in which detailed consideration is given to what a cedant is required to prove in order to recover under a reinsurance contract in a "dual-proviso" "follow the settlements" clause, commonly used in the London treaty market.

Mr. Justice Gross expressed the hope that his decision might *"kick-start"* an unwinding of the LMX spirals in question based on actuarial modelling.

## Facts

### The LMX spirals

By writing excess-of-loss cover on excess-of-loss cover, a complex and intertwining network of mutual reinsurance – the spiral - was created.

Upon the occurrence of large losses, the reinsureds made claims on their excess of loss covers. By passing on claims and liability through several contracts of reinsurance/ retrosurance, the individual losses became magnified at each stage of the upward spiral until they reached values which dramatically exceeded the original assessment and rating of the risk. Eventually, payments on reinsurance contracts in the London market were stopped.

In *Equitas*, due to the complexity of the individual contractual relationships, it was common ground that, realistically, the factual basis of the spiral could not be recreated entirely and in every detail.

<u>*Equitas* facts</u>

The spiral in *Equitas* was initiated by two separate loss events taking place between 1989 and 1991.

On 24 March 1989, the oil tanker “Exxon Valdez” ran aground in the Prince William Sound in Alaska, spilling 40,000 tons of crude oil onto 2000 km of fragile arctic ecosystem.

The Exxon losses, largely allocable to clean-up costs resulting from pollution caused by the grounding of the “Exxon Valdez”, included elements which were later found to have been irrecoverable (*Commercial Union v. NRG [1998] 2 Lloyd’s Rep 600 and King v. Brandywine Reinsurance Co.* [2005] EWCA 2350).

Second, in August 1990 Iraq invaded Kuwait and thus seized control of the Kuwait International Airport. Situated at the airport at the time of the invasion were 15 aircraft owned by Kuwait Airways Corporation (‘KAC’) and one aircraft owned by British Airways (‘BA’). In the course of events, the KAC aircrafts were transferred to Iraq and the BA plane was grounded at the Kuwait airport until February 1991, when it was destroyed by coalition forces during operation “Desert Storm”.

The KAC losses entered the LMX spiral in the early 1990s. However, as it was later determined, the losses attributable to KAC and BA were erroneously aggregated by treating them as if they had resulted from one event (*Scott v. Copenhagen Re Co. (UK) Ltd* [2003] Lloyd’s Rep IR 696).

The ‘faulty’ parts of both Exxon and KAC claims were subsequently passed through the LMX spiral and thereby magnified. Both claims increased in value until, by the year 2000 (Exxon) and 2002 (KAC), when Lloyd’s reinsurers stopped settling inter-syndicate claims, each claim had reached a sum of approximately USD6 billion.

In order to strip the aggregated claims off their ‘faulty’ elements, Equitas invested heavily, in terms of both time and resources, in the creation of an actuarial model which demonstrated, hypothetically, the passage of the Exxon and KAC losses through the spiral by taking into account the effects of leakages in the spiral, vertical and horizontal exhaustion of reinsurances, reinsurers' insolvencies and commutations.

<u>Case law</u>

To incorporate a ”follow the settlements” clause into a contract of reinsurance is a method of binding the reinsurer to the payment made by the reinsured upon the original contract. If a reinsurance contract does not contain such clause, the reinsured is put to strict proof that the loss is covered under the original policy as well as under the contract of reinsurance.

In relation to the interpretation of the particular “follow the settlements” clause at issue in *Equitas*, Mr. Justice Gross had to consider a series of judgments rendered in relation to the scope and meaning of “follow the settlements” clauses and the question of whether such clauses compelled the reinsurer to follow the contractual fortunes of the reinsured.

Specifically, the judge was bound by the ruling of the House of Lords in *Hill v. Mercantile and General Reinsurance Co. plc, Berry v. Mercantile and General Reinsurance Co. plc* [1996] 3 All ER 865, which focused on a form of clause that, as the parties agreed, operated in the same way as the clause under consideration in *Equitas*.

In order to demonstrate the importance of Mr. Justice Gross' decision in the evolution of "follow the settlements" clauses under English law, a brief outline of the most relevant legal precedents is set out below.

*Chippendale .v Holt*

In *Chippendale v. Holt* [1895] 1 Com. Cas.197, it was decided that, in a contract between a retrocedant and a retrocessionaire, the expression *"pay as may be paid thereon"* compelled the retrocedant to show that the loss was covered by the original policy and that payment was honestly made.

Consequently, a reinsurer was not required to follow the settlements of the reinsured, unless the liability of the reinsured under the original policy was proved.

*Scor*

Following the decision made in *Chippendale v. Holt* and in order to prevent reinsurers from disputing insurers' liability under the original insurance contracts, a new formulation was created which stated that the reinsurer had to *"follow the settlements"* of the reinsured.

In *Insurance Company of Africa v. Scor (UK) Reinsurance Co Ltd* [1985] 1 Lloyd's Rep. 312, the new formulation was put to the test. In this instance, the "follow the settlements" clause in this case read:

*"Being a Reinsurance of and warranted same…terms and conditions as and to follow the settlements of the Insurance Company of Africa…"*

The Court of Appeal held that, under this clause, the reinsurer was bound by any settlement reached between the insurer and the insured in relation to liability or quantum if the insurer could establish that he: (1) acted in good faith and without fraud and collusion; (2) did take all proper and businesslike steps to ascertain fairly and carefully the liability for and the amount of the loss and (3) that the claim fell legally within the terms of the reinsurance contract.

Accordingly, insurers were no longer required to show that, as a matter of law, the claim fell within the risks covered by the underlying insurance contract and reinsurers, therefore, were automatically precluded from re-litigating the question.

*Hill v. Mercantile*

In 1996 however, the House of Lords had to decide a case (*Hill v. Mercantile*) which was based on the same facts that are at issue in *Equitas* discussed here (the KAC claims) and regarding outward reinsurance contracts which contained a "follow the settlements" provision which was evidently different from that at issue in *Scor*:

*"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."*

Accordingly, the Law Lords distinguished *Hill v. Mercantile* from *Scor*. The above clause was construed to bind the reinsurer to follow the settlements of the reinsured, provided the settlements were within the terms of both the original and the reinsurance policies.

The Law Lords also established that proof is required in relation to the fact that the reinsured's settlements are within the cover of the underlying policy as a matter of law and that the relevant proof had to be provided to a standard of a balance of probabilities.

However, the House of Lords's judgment did not contain a decision as to the manner in which the above had to be proved. Neither did the "follow the settlements" provision regulate that issue.

Equitas subsequently applied for declaratory relief to the London Commercial Court, asking the Court to confirm that its recoverable losses were capable of being proved and that it succeeded in proving them through the use of actuarial modelling.

<u>The issues</u>

The first question the Court sought to answer was whether, in applying the findings of the House of Lords in *Hill v. Mercantile*, Equitas was required to prove liability and quantum of its loss upwards through the entirety of the spiral and, therefore, based on all contracts of reinsurance involved.

Secondly, the Court sought to establish by which means it could be demonstrated that a correctly aggregated loss had reached the relevant attachment point of the reinsurance contract in question and whether the actuarial model employed by Equitas was capable of achieving this objective, when it was common ground between the parties that the actual spiral could not be replicated.

<u>The arguments</u>

Equitas' argued that its recoverable losses could be proved and that it succeeded in proving them through the use of actuarial modelling.

R&Q argued instead that, in order to meet the burden of proof established in *Hill v. Mercantile*, Equitas was required to replicate precisely its losses upwards through the spiral and, by doing so, to strip the claims off their 'faulty' elements, leaving a minimum recoverable amount properly due under the reinsurance contracts. R&Q

contended that the actuarial model, developed by Equitas as a hypothetical model based on probabilities, was unsuitable of achieving this objective and that Equitas, therefore, was entitled to recover nothing.

In response, Equitas acknowledged that the model merely created an imprecise replica of the spiral but also argued that nothing required it to prove a loss at each level of the spiral or to prove the scientifically exact extent of loss once liability has been established.

## Analysis

Decision in relation to the standard of proof and "follow the settlements" clauses

In his judgment, Mr. Justice Gross recognised that any formulation of "follow the settlements" clauses served to balance the conflicting interests of the reinsured and the reinsurer. He opined that, on one hand, the reinsured wishes to bind the reinsurer to its method and the particular outcome of settling claims; on the other hand, the reinsurer wishes to prevent a situation in which he becomes liable for a risk that he did not intend to cover.

In accordance with the House of Lord's judgment in *Hill v. Mercantile*, Mr. Justice Gross ruled that the dispute had to be confined to the settlements between syndicates - R&Q and ACE - and those immediately below them in the chain – Equitas - and did not involve the contractual relations between participants of the entire spiral. In this context, Mr. Justice Gross referred to the fact that insurance and reinsurance contracts are independent of each other, a fact that was recently re-confirmed by the House of Lords in its decision in *Wasa v. Lexington* (*Wasa International Insurance Company Ltd v. Lexington Insurance Company; AGF Insurance Ltd v Lexington Insurance Company [*2009] All ER (D) 328 (Jul)*;* see also CM Report, Volume 3, 2009, 28).

Mr. Justice Gross went on to state that the question of whether the attachment point of the next layer of excess of loss cover was reached by a particular loss, was a question of law. The question of how to prove that this had occurred, however, was a question of fact and this was the matter at issue in *Equitas*.

Mr. Justice Gross observed that neither the applicable case law (particularly *Hill v. Mercantile)* nor the relevant contracts specified the means by which proof had to be presented and he acknowledged that the content of such evidence must vary from case to case. He therefore determined that proof was required to a standard of probabilities and that Equitas was free to provide any kind of proof it deemed suitable to correspond with that standard. Mr. Justice Gross saw the above confirmed by the LMX market practice, where strict proof of loss was not required by or from a market participant in the settlement of losses at the time of the conclusion of the reinsurance contracts.

The actuarial model

In Mr. Justice Gross' judgment, the actuarial model employed by Equitas served to provide satisfactory proof based on a balance of probabilities and the learned Judge was convinced that the model was capable of providing *"a reasonable representation of reality"*.

The model determined Equitas' minimum recoverable loss at 86.5% of its KAC claims and 75% of its Exxon claims.

## Learning Points

It was announced on 14 December 2009 that R&Q and Equitas settled the claims.

However, regarding Mr. Justice Gross' decision in relation to the adequacy of actuarial modelling, it remains to be seen whether his findings will trigger a general unwinding of affected LMX spirals. The factual circumstances of this case are quite unique and any actuarial modelling initiated in similar cases is likely to be costly and time-consuming. Conversely, it has now been confirmed that it is possible for a reinsured to prove a loss on a hypothetical factual basis.

In relation to Mr. Justice Gross' ruling regarding the interpretation of the "follow the settlements" clauses, it seems clearer to what extent and how the reinsured is required to provide proof under the clause. The judgment confirms that there can be several means by which the burden of proof resting on reinsureds can potentially be satisfied.

Nevertheless, English law, as it stands after Mr. Justice Gross' decision, still requires reinsureds to adhere to strict requirements in order to successfully claim losses from reinsurers and it is their duty to handle insurance claims in a professional and careful manner. Most importantly, it is not sufficient for a reinsured to accept liability (and pay) and then seek reimbursement from reinsurers. Whether or not the contract of reinsurance is based on a specific "follow the settlements" provision, reinsureds must be prepared to show that they:

(1) recognised a claim under their insurance policy;

(2) deemed it capable of coverage;

(3) settled the claim properly; and

(4) can prove that the claim falls within the terms of the reinsurance contract.