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IMPLICATIONS OF WASA AND EQUITAS CASES' DECISIONS

By Lindsay McQuillian

2009 heralded a pair of long-awaited decisions for London market reinsurers. *Wasa v Lexington* went before the House of Lords in the summer, followed (after several stays as the parties tried and failed to reach a market solution) by *Equitas v R&Q* debating fallout from the LMX spiral in the High Court. The major features of each case are discussed below.

Wasa v Lexington

The House of Lords' judgment in *Wasa v Lexington* at the end of July 2009 was anticipated to be one of the most significant reinsurance decisions in recent years. Calling into question the reliability of back to back reinsurance cover, the Lords found in favour of reinsurers Wasa and AGF, upholding the English law meaning of a period clause in a reinsurance contract despite an alternative conclusion reached by a U.S. court on the same clause in the direct policy. In fact, the judgment of the Lords was perhaps not quite so groundbreaking as expected.

The direct policy was issued by Lexington in the U.S. to the Aluminium Company of America ("**Alcoa**") for the period 1 July 1977 to 1 July 1980. Alcoa issued proceedings against Lexington for contamination clean-up costs spanning the period 1942 to 1986. The Supreme Court of Washington, holding that the policy should be governed by Pennsylvania law (it contained no express choice of law clause), ruled that Lexington was liable to indemnify Alcoa for the entire period during which the contamination had occurred, provided that at least some of it occurred during the policy period. Lexington sought to recover the sum of its eventual settlement with Alcoa under proportional facultative reinsurance contracts. However its reinsurers claimed that the reinsurance, which was governed by English law, would only allow for recovery of those losses incurred during the policy period.

In favouring the reinsurers' position, and applying English law to the interpretation of the policy period in the reinsurance, the House of Lords placed important limits on the principle (as set down in *Vesta v Butcher* and *Groupama v Catatumbo*) that when a reinsurance and a direct policy are governed by different laws, terms incorporated from the direct policy into the reinsurance contract should have the same meaning and effect as in the direct policy. Key to the decision in *Wasa* to distinguish it from these previous cases was the conclusion that when the policies were entered into, it would not have been clear to the parties that Pennsylvania law would apply to the direct policy. As a result, the reinsurers would not have been able to refer to a hypothetical "foreign legal dictionary" (as characterised in *Vesta*) to ascertain by what law coverage under their proposed contract would be determined.

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The case has a number of implications. Most obviously, it means that parties to a multi-jurisdictional reinsurance contract should ensure, if they wish the reinsurance to operate in a back to back manner, that the governing laws of both the reinsurance and the underlying direct insurance are at the very least identifiable (and ideally identical) at the time the reinsurance is purchased. Even if this were the case however, the Lords' judgment rejected the proposition that where the language of the reinsurance and direct policies is identical, the contracts should be treated as being back to back, saying instead that the construction of a particular reinsurance contract should depend on its relevant background and surrounding circumstances. It seems therefore to have increased uncertainty about the extent to which parties can assume a reinsurance will be treated as back to back. It is notable that *Wasa v Lexington* involved a proportional facultative contract, which might be expected to have provided the firmest grounds for back to back cover, so that categories of reinsurance less closely connected to the underlying policy such as treaty reinsurance may arguably be even more vulnerable.

For reinsurers with exposure to certain long tail asbestos and contamination liabilities in the U.S., the decision does provide some comfort in its preference for an English law interpretation of policy period.

Equitas v R&Q

November 2009 saw judgment handed down in the closely followed case of Equitas v R&Q Reinsurance Co, with significant consequences for participants in the notorious LMX reinsurance spiral. The trial saw Equitas facing an uphill battle to establish that run-off reinsurer R&Q is liable to pay claims originating from the Exxon Valdez oil spill and Kuwait Airways losses during the first Gulf war. The LMX market had wrongly aggregated certain losses and included irrecoverable losses within the sums claimed. Mr Justice Gross ruled on whether Equitas could use complex actuarial modelling techniques to prove claims against reinsurer R&Q beset with "rogue" elements in the form of irrecoverable and wrongly aggregated losses. Ultimately, the parties agreed that the hugely complex, intertwining web of mutual reinsurances making up the spiral could not realistically be "unravelled" in accurate detail by conventional methods. The key battleground was whether Equitas could present its claims to the required standard without reconstructing the spiral, instead relying on generalised actuarial analysis – described by R&Q as "guesswork".

Finding in favour of Equitas, Gross J stated that the "reasonable representation of reality" provided by Equitas' models did "practical justice" in the case, and were "emphatically preferable to leaving the losses to lie crudely where they fall". Acknowledging that Equitas was obliged to discharge the burden of proving its losses, Gross J commented that there were no objections at law to it using actuarial models to do this. Whilst the reinsurance contracts involved placed a burden on Equitas to prove its claims on the balance of probabilities, there was nothing in those contracts to dictate HOW that burden was to be discharged. Gross J found that the models were capable of establishing a minimum figure for the recoverable losses of each syndicate to a standard balance of probabilities.

The relevance of market practice was an interesting feature of this case as of course, market practice had ultimately failed to pinpoint a solution to the parties' unprecedented situation. Gross J's view was that to the extent market practice could be of limited assistance, it tended to favour the arguments of Equitas, that strict proof of loss tracing claims through all underlying layers in a chain of reinsurance was surplus to requirements. Gross J characterised the LMX market as a "good faith" market which took a pragmatic approach to the collection of losses

in order to avoid "collapse beneath a sea of enquiry" if strict proof of loss was demanded at each turn of the spiral.

Despite stating after the judgment that it was considering grounds for appeal, on Monday 14 December it was announced that R&Q had reached a settlement with Equitas. It stated that the settlement would result in pre-tax losses to R&Q of less than £5 million.

The decision has huge financial consequences for other LMX players as various disputes and payments frozen pending the outcome of Equitas' test case can start moving again. It is estimated that over £600 million of outstanding claims may be affected, and of course, Equitas itself may now proceed to present its models to other reinsurers. The judgment sets a precedent for use of the actuarial models in establishing claims, but acknowledges that there might be factual situations where it would be appropriate to reconstruct each level of the spiral. Notably, in his detailed analysis of Equitas' approach to the modelling, Gross J placed emphasis on certain features such as its conservative assumptions and discounting which reinsureds attempting to replicate Equitas' success may be advised to heed.