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UNRAVELLING THE SPIRAL

By Lindsay McQuillian and Susannah Wilks

LMX reinsurers are on tenterhooks awaiting the handing down in October of judgment in the long running dispute between Berkshire Hathaway's Equitas and R&Q Reinsurance (formerly Brandywine). The closely followed 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 reinsurance and retrocession-level contracts involved are heavily entangled in the LMX spiral, and next month's decision from Mr Justice Gross could see the unwinding of the notorious spiral finally beginning in earnest.

Of the 26 "test cases" examined at the trial (a tiny proportion of 4,000-plus disputed claims hanging in the balance), 14 related to the Kuwait Airways losses and 12 to Exxon Valdez. The Kuwait Airways claims raise the well-known issue of the incorrectly aggregated British Airways loss (following *Scott v Copenhagen Re*). The Exxon Valdez claims are encumbered with elements ruled irrecoverable under Exxon's GCE policy in *King v Brandywine*. Both of these decisions had far reaching effects on the spiral, paralysing payments in relation to thousands of contracts. In addition, the Kuwait Airways loss is affected by US$139 million of refunds paid to Equitas on behalf of Iraq via the United Nations Compensation Commission (**"UNCC"**). During the closing stages of the trial, Gross J expressed particular concern not to see injustice done in the redistribution of those refunds.

The dispute is framed in terms of the standard of claims presentation. R&Q's case is that Equitas must present (or in many cases, re-present) its claims appropriately stripped of the irrecoverable British Airways and Exxon Valdez losses, and adjusted to take account of the effect of the UNCC refunds. Equitas agrees – in theory – that this adjustment should and will take place. The real question is how – and whether it is even possible. Equitas asserts that the adjustments can be made by way of complex actuarial modelling.

One of the crucial questions is whether Gross J will accept Equitas' application of these actuarial modelling techniques to the spiral, to determine those proportions of the liabilities properly falling at R&Q's door. Clearly, the reverberations around the spiral of factors such as the British Airways loss, the irrecoverable Exxon Valdez losses, and the effect of the UNCC rebates, are no easy matter to follow, having been magnified, distorted or lost to view by the spiral's turns. The position is further complicated by a number of "roadblocks" as characterised by Gross J, thrown up in the form of commutation agreements at various levels which may or may not have accounted for these elements, and in respect of which rights have been reserved.

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Equitas acknowledges that the spiral's effects make the losses impossible to quantify by any conventional method, and is yet to assign a definitive value to the claims, relying instead on projected figures obtained from its modelling. It was not for some time after originally serving its pleadings in October 2007 that Equitas fully articulated the quantum of its claim.

Not only does R&Q argue that Equitas must account for the readjustment of its own claims, it must also prove that the underlying contracts have been validly exhausted, in the light of the adjustments. Equitas maintains that it has presented the claims to R&Q to the required standard, and that as a matter of market practice, it is not necessary to prove the relevant losses at every level of the underlying reinsurance chain. Alistair Schaff QC for Equitas stressed to the Court that it is the inwards settlement to the reinsured which counts. During the trial, R&Q argued that no market practice is available to shed light on this unprecedented situation (and indeed, attempts to find a market solution have met with failure). Equitas admitted this to some extent, whilst maintaining that market practice is relevant to the construction of the clauses governing proof of loss in the retrocessional contracts – in this case indicating that comprehensive exploration and documentation of the sequence of underlying claims is not required.

Furthermore, Equitas argued it is not necessary to trace the exact pathway of the losses through the spiral to ascertain what effect will be had on the ultimate net loss, once the irrecoverable elements are stripped out. It claims the models of the spiral it has developed are capable of demonstrating the contribution of these adjustments to the bottom line figure. These models have produced the figure of US$1.43 billion as the lowest overall estimate of the claims arising from both the relevant events – a stark illustration of the potential scale of the matter. However, John Lockey QC for R&Q stated that these models can do no more than approximate the reality of the situation, and overlook many of the spiral's features. He characterised the modelling as a "blunt tool". Equitas responded that R&Q's fears are exaggerated, and emphasised that the standard of proof required is the balance of probabilities. According to Mr Schaff, "we can't be sure" is not the correct line to take.

Certainly, if Gross J accepts the losses as projected by the model, it will set an important legal precedent (albeit, one almost certain to be appealed). There is real potential for further satellite litigation arising out of this unfortunate state of affairs. One thing seems clear – until the spiral starts to move, the consequences of its unravelling are well nigh impossible to predict, for either the parties themselves or the multitude of LMX players with claims frozen pending the verdict.