In the Court of Appeal (Civil Division) **Case No.: A3/2004/1441**

Application for Permission to Appeal

from the High Court of Justice
Queen's Bench Division, Commercial Court

between:

Richard A. Tropp

Appellant/Defendant

- and -

The Society of Lloyd's

Respondent/Claimant

Appellant's Supplemental Skeleton Argument

This is Tropp's supplemental skeleton argument, further to his skeleton of 19 July, in support of his Appellant's Notice of 5 July 2004.

Defences under general law of insurance, and leading authority, brushed aside (relevant to Grounds for Appeal issues IV and V)

1. In his Part 24 skeleton argument, Appellant had pleaded at § 37: "[Tropp] is not only a party to contract and an underwriter... but also a reinsurer. He was made, as evidence he has submitted shows, inadvertently to have become a `reinsurer'... almost entirely of already known losses embedded in prior-year IBNR [carryforward of Incurred But Not Reported liability, not yet crystallised into current notified claims], rather than contemporaneous underwriting. There is developing law on what `insurance' is in law and what it is not, and on what reinsurance is in law and is not. (See e.g. **Sphere Drake** cited at § 16 above). In respondent's capacity as a mostly inadvertent reinsurer, there are defences... under UK insurance law...."

2. Appellant further had pleaded in his Part 24 skeleton § 38: "[He] was also an insured policy-holder, on whose behalf managing agents of his syndicates bought reinsurance within the Lloyd's market, for which they paid pro rata with his capital. Those reinsurances have not protected him as a policy-holder.... In his capacity as an insured policy-holder, there are defences... under [general] insurance law, and in that capacity he arguably is not limited by the Lloyd's Acts. He reserves such defences... under... insurance law."

In R&R itself, moreover, Tropp was induced to be an assured in Equitas. In relation to R&R, the law that protects assureds is engaged as to the duties of disclosure owed to him from the reinsurer side, arguably by Lloyd's as the party which effected the reinsurance.

Such duties of disclosure may have especially been strict in the fact context: Tropp might not have needed reinsurance into Equitas in R&R in the first place if **Lloyd's** had not instructed the managing agents of his long-tail syndicates listed in Schedule H of the Particulars to go into run-off, rather than reinsure to close ("RITC") their IBNR projected liabilities which were still decades away from becoming

notified claims currently due and payable. It was directly because of this 1991 requirement by Lloyd's that his later year syndicates, which otherwise might have protected him by reinsurances to close, had become unable to cover the Schedule H liabilities from his earlier year syndicates that are now claimed by Lloyd's against him.

3. At § 16 of his Part 24 skeleton, Appellant had relied on Sphere Drake v Euro International, Stirling Cooke Brown & Ors [2003] EWHC 1636 (Comm) as insurance law authority when pleading triability as against summary disposal: "The CA in **Hughes** (at § 22) [2004 EWCA] quoted Lord Browne-Williamson in **Barrett** [2001 HL] on when especially [the court should be loath to shut out a defence]: `"[I]n an area of the law which was... developing... it is not normally appropriate to strike out.... [I]t is of great importance that such development should be on the basis of the actual facts found at trial not on hypothetical facts assumed (possibly wrongly) to be true..."' (N.b. please... as to evolving law: consider the recent holding on a `spiral' involving Lloyd's' LMX syndicates in **Sphere Drake...**, then compare the **Sphere Drake** issues to §§ 19-21 in Tropp's defence....)"

The Part 24 hearing transcript [which Tropp has been refused] would show that the court uncharacteristically interrupted him as he was beginning to make his point relying on Sphere Drake as leading authority in the relevant general law of insurance, cautioned him archly that he should be careful, the Part 24 judge was familiar with Sphere Drake, and dismissively cut off the point he was about to make in reliance on the holdings of law in that judgment. Tropp simply never got to run this lead authority and his insurance law argument at all.

As he will plead below in analysis of Sphere Drake, it was an error of law for the Part 24 court to have not considered that case's holdings as authority for finding triability of Tropp's defences now presented to this court in issues IV and V of his Grounds for Appeal.

4. § 19 in Appellant's Defence and Counterclaim was "**Not `insurance'; claim arguably not from `insurance business'**". § 20 was entitled "**Not `reinsurance'**, either". § 21 was entitled "Claim not within the authority of statutory basic business model." Please review them at pp. 7-10 of the Defence and Counterclaim, and please review also the evidentiary materials cited and relied on in them, as prologue to what follows on the authorities in the law of insurance generally, and on Sphere Drake as relevant leading authority in particular.

Appellant's evidence cited at § 3 first para and § 3(d)-(e) of his skeleton argument (n.b. in Defence §§ 17-26), and the sample evidence explained at § 3(a)-(c) to give the court a flavor of what his fresh evidence shows, suggest that at best his long-tail syndicates listed in Schedule H of the Particulars were "trading in losses" within the precise meaning of Sphere Drake at paras 7(viii) and 157(ii), without the disclosure to their capital providers held to have been required.

Appellant's evidence further shows that those particular syndicates' agents were "churning" fees out of insurance reserves built on the capital of their principals, depleting reserves, within the meaning of paras 7(ix) and 177(iii). Materially all that these syndicates

did, in the years of account listed in Schedule H and attributed to Appellant, was to "transfer losses" (para 177(i)) already previously incurred onto "innocent capacity" (section heading 2(8)(j) at para 291) "...to whom the losses could be passed who did not understand the business and would therefore accept the losses from those that did...." without commensurate consideration (para 336(iv)).

5. The provenance of Tropp's evidence also shows that the Corporation of Lloyd's, who now pursue him to bear IBNR future liabilities from, precisely, such "trading in losses" that was held in Sphere Drake at para 22 to be "grave dishonesty" and "a chronicle of deception", knew internally at the time of their claim (and well before) the true nature of the Schedule H losses they have stated to the court are his.

Appellant's evidence may show that by their proceedings against him, the Corporation knowingly has in effect continued to "cover" (in the colloquial) for such undisclosed "trading in losses" and "churning" by particular listed syndicates' managing agents, who had before R&R been also insiders at the Corporation officer and Council level.

If so, such a motive of covering would meet the HL's Horrocks v Lowe [1975] AC 135 standard (at pp. 150-51) for "improper purpose" by the Corporation "to obtain some private advantage". Such motive, "unconnected with the duty or the interest which constitutes the reason for the privilege [in judicial proceedings]", would be an abuse of the privilege for a purpose outside the policy intent of its protection.

Liabilities claimed were not in law "insurance": not a fortuity, but inevitabilities (ultra vires statutory authority, contract)

6. "Is there then something special about insurance [for applying to it the stringent uberrimae fide duty of disclosure]? Insurance is about risk...." Drake Insurance v Provident Insurance [2003] EWCA Civ 1834 at para 71 (Rix LJ). Loss was held not covered by marine insurance in Ikerigi CNSA v Palmer (The Wondrous) [1991] 1 Lloyd's Rep 400 [Comm] at 416 (Hobhouse LJ) when found in fact to have been not "fortuitous": "It did not happen by chance", ergo was "not a risk".

See Clarke on Insurance (3rd ed) at § 17-3A "Fortuity": "Loss is fortuitous unless it was inevitable... at the beginning-- the beginning of cover or at the time that the contract is made...." At § 17-3A1 "Inevitable Loss": "All risks insurance is not cover against all causes of loss but against all **risks** of loss; it `covers a risk not a certainty'". British & Foreign Marine Ins Co Ltd v Gaunt [1921] 2 AC 41, 57 per Lord Summer (cargo), other authorities cited at fn 116.

"In England,... the general rule against cover of losses that are in some sense inevitable is based on... the notion of risk.... The effect is to exclude loss suffered **before** the date at which the... risk is assessed. ...[A]n allied effect is the exclusion of loss which, although it has not occurred at that date, has become **inevitable** at that date." [Clarke 17-3A1 at p. 409]

"[A]n insurance risk can only properly be appreciated... [at] a point in time **before** the risk has been run...." There must "at **that** time"

be "a risk of loss" rather than "a certainty of loss". [Clarke 17-3A2 "Knowledge"; cf. fn 130 on that distinction, Soya GmbH v White [1982] 1 Lloyd's Rep 136 (CA), at 150 by Donaldson LJ (cargo)].
The Wondrous "fortuity" test was applied recently in AMEC Civil Engineering v Norwich Union [2003] EWHC 1341 (TCC) at para 73. Under other names, it is settled doctrine: the essence of a contract of insurance is an undertaking, for consideration, to provide compensation for loss suffered in an **uncertain** event In re Sentinel Securities [1996] 1 WLR 316 (Ch) [guarantee protection against financial failure of a supplier]; contract which met that test was held enforceable as "insurance business" within the ordinary meaning of that term.

In Carter v Boehm (1766) 3 Burr. 1905 (KB), the non-marine insurance lead case in which Lord Mansfield first stated what became the common law of non-disclosure and concealment, he characterised insurance as "a contract upon a speculation", one of "contingent chance" (at 1909, quoted Pan Atlantic & Anor v Pine Top [1995] 1 AC 501 [HL] at 622).

7. Sphere Drake applied this model, contrasting "not the **fortuity** of loss, but the **inevitability** of loss" [296] in the WC carveout spiral the court was examining, and "a genuine fortuity" in the catastrophe market versus "inevitable" losses in the WC market [174(ii)]. The effect of its spiral was that enormous losses were "inevitable" [at 153, 245(i), 307]; it "transfer[red] losses rather than **the risk of** losses" [177(i)]. The contrast was between a market "...where a **chance** would be taken on the happening of a loss; [and the SD one in which] losses on a massive scale were **inevitable**" [260(ii)], as well as already "known" [7(vi)] to be coming in excess of premium.

8. A statutory counterpart to the "not a fortuity" point is Marine Insurance Act 1906 ("MIA") § 39(5): "...where, with the privity of the assured, the ship is sent to sea in an unseaworthy state, the insurer is not liable for any loss attributable to unseaworthiness." For an insurer to avoid a claim, "there must have been unseaworthiness **at the time** the vessel was sent to sea" and "the assured must have **been privy to** [had knowledge he was] sending the ship to sea in that condition". Manifest Shipping v. Uni-Polaris & Ors [2001] UKHL 1 at para 16. Unseaworthiness raises an inference of inevitability.

9. See Appellant's Defence & Counterclaim § 19(b). The liabilities of his particular long-tail syndicates listed in Schedule H were not, in his particular years of account, materially true "insurance" loss: they fail the "fortuity" test, because inevitable.

The evidence summarised at § 3 of his skeleton shows that they were by the time of R&R (a fortiori, by the date of the claim) known by Lloyd's to have **been** inevitabilities from day one of Appellant's years of account. Notwithstanding having been privy within the meaning of Manifest at the time of R&R, Lloyd's now claim against him as if the liabilities had arisen in his years from "insurance business". Lloyd's knows better; they had the internal confidential sample evidence described at § 3(a)-(c) of his skeleton long before he did.

Deliberate avoidance, "blind-eye knowledge", is failure to meet insurance law utmost good faith duty of disclosure; claim voided

10. Privity, as an element of culpable non-disclosure, may be "...a state of mind... equivalent to knowledge... `blind eye knowledge.... The expression was used by Lord Denning MR in The Eurysthenes [1977] QB 49 at 68 in relation to a defence [against a claim] of privity under s.39(5) [Marine Insurance Act 1906]...: `...when I speak of knowledge, I mean... also the sort of knowledge expressed in... "turning a blind eye". If a man, suspicious of the truth, turns a blind eye to it, and refrains from inquiry -- so that he should not know it for certain -- then he is to be regarded as **knowing** the truth. This `turning a blind eye' is far more blameworthy than mere negligence... [which] is not equivalent to knowledge of it." (Manifest, § 8 above id at paras 23-24, Lord Hobhouse and para 113, Lord Scott).

Geoffrey Lane LJ in Eurysthenes (at 81) imputes such privity to "`the man who deliberately turns a blind eye... to avoid obtaining certain knowledge of the truth.'" Roskill LJ (at 76) added, "`If the facts amounting to unseaworthiness are there **staring the assured in the face** so that he must, had he thought of if, have realised their implication upon the unseaworthiness of his ship, he cannot escape from being held privy to that unseaworthiness by blindly or blandly ignoring those facts or by refraining from asking relevant questions... in the hope that by his lack of inquiry he will not know for certain that which any inquiry must have made plain beyond possibility of doubt.`" (Manifest para 24, Lord Hobhouse and para 114, Lord Scott).

"Nelson at the battle of Copenhagen made a deliberate decision to place the telescope to his blind eye in order to avoid seeing what he knew he would see if he placed it to his good eye. ...[I]mputation of blind-eye knowledge requires an amalgam of suspicion that certain facts may exist and **a decision to refrain** from taking any step to confirm their existence." Lord Blackburn in Jones v Gordon (1877) 2 App Cas 616, 629 distinguished [honest carelessness] from a person who `**refrained** from asking questions... because he thought in his own secret mind -- I suspect there is something wrong, and if I ask questions..., it will no longer be my suspecting it, but my knowing it, and then I shall not be able to recover.' Lord Blackburn added `I think that is dishonesty.'" (Manifest para 112, Lord Scott).

Deliberate refraining from inquiry is beyond gross negligence; it is a "state of mind which the law treats as equivalent to [direct] knowledge" (for purposes of imputing privity; id at 25, Lord Hobhouse). "If the shipowner **deliberately** refrains from examining the ship in order not to gain direct knowledge of what he has reason to believe is her unseaworthy state, he is privy to the ship putting to sea in that unseaworthy state." (Id at 26). "In summary, blind-eye knowledge requires... a suspicion that the relevant facts do exist and a **deliberate** decision to **avoid** confirming that they exist." (Id at 116, Lord Scott; applied by CA in Drake § 6 above at para 173, Pill LJ).

11. When a party has been "**shutting his eyes** to an obvious means of knowledge" by having "**deliberately refrained** from making inquiries the results of which he might not care to know", he is deemed to have knowledge. When one has been "deliberately refraining from making inquiries, the result of which [he] does not care to have," then "...

shutting the eyes is actual knowledge in the eyes of the law." Roper v Taylors Central Garages [1951] 2 TLR 284 (Div Ct), at 288-89, Devlin J, quoted in Price Meats v Barclays Bank [1999] EWHC Ch 190 at para 11. The expression "shut his eyes" "...produces in judges a reflex image of Admiral Nelson at Copenhagen and the common use of

this image by lawyers to signify a **deliberate abstinence** from inquiry in order to avoid certain knowledge of what one suspects to be the case" Twinsectra v Yardley & Ors [2002] UKHL 12 at para 22, Lord Hoffmann, citing Lords Hobhouse and Scott in Manifest.

12. In Twinsectra "The Court of Appeal [Potter LJ]... concluded that deliberately shutting his eyes... was **dishonesty**..." within the analysis of Royal Brunei Airlines v Tan [1995] 2 AC 378 (Lord Nicholls), when considering accessory liability in equity (Twinsectra HL id § 11 above at paras 3, Lord Slynn and 33, Lord Hutton).

Applying both concepts in the tests of accessory liability, "It is **dishonest** for a man **deliberately to shut his eyes** to facts which he would prefer not to know. If he does so, he is taken to have actual knowledge of the facts to which he shut his eyes. Such knowledge has been described as `Nelsonian knowledge', meaning knowledge which is attributed to a person as a consequence of his `wilfull blindness' ...." (Id at para 112, Lord Millett). This would go to establishing dishonesty in a claim for "knowing assistance" in equity ("the equitable counterpart of the economic torts"), when considering accessory liability (id at para 127(3), Lord Millett).

13. "Deliberate silence" when one owes a duty of disclosure, on such shutting of the eyes or deliberate refraining, is deemed "a silence with knowledge" which may amount to a representation (Price Meats id § 11 at paras 8-9). It is "an important but uncontentious point: that silence, where there is a duty to speak, may amount to misrepresentation". HIH Casualty and General & Ors v Chase Manhattan & Ors [2003] UKHL 6 at para 21 (Lord Bingham), citing Rix LJ in HIH Casualty v Chase [2002] EWCA Civ 1250 at para 168.

Moreover, a non-disclosure "which makes a positive statement misleading -- the half-truth which, without disclosure of the other half, is ... `no better than a downright falsehood'", may amount to a deceit; "such half-truths would be actionable" by the insurer. HIH [HL] at para 71, Lord Hoffmann. It would be "a dishonest breach of that duty" of disclosure by an assured or his agent to the insurer "`where there is a duty or an obligation to speak, and a man in breach of that duty or obligation holds his tongue and does not speak, and does not say the thing he was bound to say, if that was done with the intention of inducing the other party to act upon the belief that the reason why he did not speak was because he had nothing to say....'" Brownlie v Campbell (1880) 5 App Cas 925, 950, Lord Blackburn, quoted by Lord Hoffmann at HIH [HL] id at para 72. Such "dishonest" nondisclosure could give rise to a right to rescind by the insurer (id at para 75).

14. Under HIH, a principal is not permitted to take advantage of or benefit from dishonest behavior by his agent in inducing an insurance contract (at paras 76, 98, 120-21), for "the party deceived has not

given [absent due disclosure by the agent] a true consent to be bound by the contract" that was induced on the basis of such deceit (at 98).

15. This is the more so when the insurer is a relatively passive "follower"; such a follower is "entitled to rely upon a presumption of inducement" as referred to in St Paul Fire and Marine v McConnell Dowell [1995] Lloyd's Rep 116 (CA) at 127; cited International Management Group v Simmonds [2003] EWHC 177 (Comm) at para 149. The applicable law is that "A contract of insurance is a contract of the utmost good faith and in compliance with that duty the insured must disclose to the insurer all circumstances known... by the insured which are material to the insurers appraisal of the risk." (at para 136). When under this test there was "non disclosure to **the followers** of unfair presentation to the leaders", and "the following underwriters... placed considerable reliance upon the leading underwriters on this risk", it was held that "the followers were... [presumptively] induced by such non disclosure to write the risk" (at paras 150, 152).

16. The court expressly applied this standard to a Lloyd's placement: "...where... the lead underwriters were more familiar than the followers [with the risk issues in a particular insurance product market] and where one of the lead underwriters had access to greater sources of information, the reliance upon the leaders' subscription is self evident." (at para 150). "In these circumstances, the misrepresentations and non-disclosures which prevented a fair presentation of the risks to the leaders represented a material circumstance... required to be disclosed **to the followers**... to make a fair representation to them" (at para 151).

If there is a presumption of inducement (as § 15 above) and a strict duty of disclosure to professional underwriters in the Lloyd's market who are "followers", then a fortiori, would there not be the more so a presumption and an even stricter duty to passive Names who are certainly "follower" underwriters, but **not** professionals in the market?

17. The application of the duty of utmost good faith to insurance by Lord Mansfield in Carter v Boehm (§ 6 above. at 1905) "was based upon the inequality of information as between the proposer and the underwriter..." (Pan Atlantic, Lord Mustill, quoted Manifest at para 42), a conceptual framework which certainly applies to Lloyd's and Tropp. Manifest holds this duty to continue after the insurance contract as well, rather than only in the inducement to the contract (at paras 48, 59, 95), and that its breach post-contract in relation to a particular claim makes the claim "forfeit" (at 62-66) and voids it as a matter of "the policy of the law" (at 67, citing Lord Woolf elsewhere).

The philosophy is captured in the HL's review of scuttling cases and others in which, to assess privity in relation to a particular claim, the court made an order for ship's papers: "it was repeatedly said by judges that the order was made because of **a continuing** duty of good faith and disclosure owed by the assured to the insurer; for example, Matthew LJ in Boulton v Houlder Bros [1904] 1 KB 784 at 791-92 -- `It is an essential condition of a policy of insurance that the underwriters shall be treated with good faith, not merely in reference to the inception of the risk, but in the steps taken [afterward] **to carry out**

the contract.'" (Manifest 58-59, Lord Hobhouse).

Marine Insurance Act 1906 § 17 establishes that "A contract of marine insurance [in common law, non-marine as well] is a contract based upon the utmost good faith, and, if the utmost good faith be not observed by either party, the contract may be avoided by the other party." "[T]he section 17 duty has repeatedly been held to be owing in the context of [not only the whole contract or policy, but also] claims. A dishonest claim constitutes a breach by the assured of section 17 and entitles the insurers to avoid [as to that claim] the contract." (Manifest 81, Lord Scott).

18. After Manifest, "blind-eye knowledge", "deliberate refraining", "deliberate avoidance", "deliberate silence" arising from them, and related behaviors in §§ 10-13 above would breach the continued duty of disclosure in utmost good faith owed to an underwriter after contract as well as before. Under International Management and St Paul Fire and Marine, this should especially strictly apply to a "follower" underwriter, of which there could be no more passive a class than the Name who is not a working insurance professional in the London market. On the basis of such culpable non-disclosure, an insurer may, while not avoiding the insurance contract, avoid the claim.

19. Lloyd's is claiming against Tropp for a next half-century's reserves to cover claims under the IBNR liabilities listed in Schedule H. Appellant invites the court to examine again his sample evidence explained at § 3(a)-(c) in his skeleton, and to **please consider with care the schedules -- the sample raw evidence** -- cited in § 3(a) [tax filings made to government] and § 3(b) [internal analyses of the line of business breakout, and the year of original underwriting breakout, of Tropp's long-tail syndicates on Schedule H, provided by Lloyd's in confidence during R&R to the managing agents of those syndicates].

The question Appellant asks the court to consider is, do not these evidence samples (considered even without the further evidence he had prepared to submit at trial, on which please revisit § 3(d)-(e) in his skeleton), suggest the applicability of the law at §§ 10-18 above to Lloyd's' statements to Tropp and to the court about those particular syndicates? If so, was that not a question triable on his fresh evidence under the law above, as to issues IV (syndicate-specific claims ultra vires statutory authority) and V (such claims ultra vires the intent of the parties in the agreement)? Was it not error of law for the court to shut Appellant out of being able to try these issues in order to seek, under Manifest, to avoid particular Schedule H claims?

"Trading in losses" on "innocent capacity": the paradigm case

20. The closest fact matrix analogy in the insurance law authorities to what Appellant's evidence (in § 3 of his skeleton) shows is Sphere Drake (§ 3 above), so close that it is more identity than analogy. If one examines the central themes in Sphere Drake and lays them as if a template over Appellant's long-tail syndicates listed in Schedule H, the question that arises is, if those themes were triable in Sphere Drake, then why would they be not triable in the present case?

21. Exactly like the IBNR recycled self-reinsurances to close by the managing agents of Tropp's long-tail syndicates, the closed circle which the court examined in Sphere Drake was a "reinsurance market that traded in losses" (id at 7(viii), 157(ii)), a "gross loss making business" (at 151). "By gross loss making business I mean business where it is a virtual **certainty** that there will be losses which will far exceed the premium..." (at 151), written by "[agents] who deliberately [did such] business in the knowledge that the losses would [do so]." "They were trading in losses." [7(vii)].

Some such agents wrote such reinsurance "at a premium which was far less than what they **knew** they [or their retrocessionaire] would have to pay out [in] claims; they were therefore deliberately writing reinsurance **which they knew and intended** would make a gross loss; this was wholly different from conventional reinsurance...." [7(v)]. Mr. Justice Thomas's definition could have been describing the long-tail syndicates listed in Schedule H of Applicant's Particulars, and their managing agents. It is not merely an analogy; it is in commercial terms (though not structurally) materially an identity.

22. The agents who wrote such business "did so on the basis that they had outwards reinsurance" which would cover the liability they had assumed on the back of their capital providers; "They were therefore writing... on the basis that they would make a "turn" and not assessing the risk and the premium in the manner of conventional insurance .... It would... be described as deliberately accepting business known to produce losses in excess of the premium charged on the backs of reinsurers...." [7(vi]. Such underwriting "relied on outwards reinsurance to turn gross loss... into [becoming] profitable when reinsurance recoveries were brought into account." [146]

This was perhaps "...business that no honest underwriter would have accepted." [39(ii)]. "It might be asked why any reinsurer would write such business unless it was for a common commercial purposes - such as... to enter a market, ...or to cultivate the cedant or the broker in order to obtain other business.... [But in SD,] reinsurers generally wrote [that] business on a large scale where huge losses were **inevitable** because there were other reinsurers who were prepared to reinsure them on terms which enabled... a profit." [153]

"As losses were inevitable at [the lower] layers [of the reinsurance spiral] and the reinsurances were only being placed on the basis that the inevitable losses were being passed on, those doing business in the market were in fact **trading in losses**." [at 157(ii)]. "The premiums that were paid were... not commensurate with the risk of gross loss as in conventional reinsurance, but were merely to pay the retained [in long-tail IBNR, the current "pure-year"] losses, to pay the reinsurance premium and to make the turn...." [157(iii)].

The claimant SD characterised this as "a dishonest scheme or racket" [253]; the court agreed: "grave dishonesty", "a chronicle of deception", a detailed examination of the facts of which "underlines the scale of that dishonesty" [22]. It was not a commercial market: "The market was not economically sustainable as the losses were so vast. The loss ratios (which were entirely predictable) ran into hundreds of

percent,..." -- precisely as they did (and were) on Respondent's long-tail syndicates listed in Schedule H -- "demonstrating that the difference between premium and losses was so great that the business was uninsurable" [253(i)]: in fact, not a "business". "It was inevitable that passing losses to reinsurers on this scale would lead to reinsurers leaving the market or becoming insolvent." [253(ii)]

23. The underwriting managing agents were able to do this by, the court found, victimising "**innocent capacity**" [section head 2(8)(j)]: "No rational person would ever knowingly take on such losses; the market operated to dump these losses on someone **who did not know** the true nature of the business." [253(iii)] "The market was only sustainable because the knowing participants were able to cheat the ignorent through... passing the losses to them." [253(iv)] "Those `in the know' took steps to make sure the losses did not end up with them and passed on the losses to innocent victims -- ...providers of capital who had given an agency to a knowing participant who then wrote the business, or to other... reinsurers [who did not] appreciat[e] the true nature of the business." [253(v)].

The court concluded, "The prime movers in the market were prepared to write the business because they knew that there were others to whom the losses could be passed **who did not understand** the business and would therefore accept the losses from those that did for little premium." [336(iv), 282] "Full disclosure would have ended the market" [section head 2(8)(n)]: "if the true nature of the business was made known to and understood by all who participated in it, the market would obviously [have been] unsustainable." [318, 330] "There would have been no market for reinsuring [that] business... if there had been full disclosure... to those who had provided the capacity (such as Names)... or to [corporate] reinsurers...." [336(iii)].

24. "The spirals were deliberately created to move the loss to those who did not appreciate what they were accepting; it was... **creation of a false market**" [253(vi)], in the sense the term is used in Scott v Brown, Deering, McNab & Co. [1892] 2 QB 724, the spirals having been "contrived" rather than a naturally arising true commercial market [326]. The court accepted SD's analogy with pyramid schemes [at 327], as described [at 323] in Re Senator Hanseatische [1997] 1 WLR 515 (CA) at 524-25 by Millett LJ, with Lord Woolf MR concurring:

> "It is... another feature of the scheme which is far more pernicious and which gives much greater cause for concern. This is the certainty that the scheme will cause loss to a large number of people, and that the longer the scheme is allowed to continue the greater the number who will inevitably suffer loss....
>
> The number of persons who [can] be persuaded to join may be very large but... obviously finite; so is the amount of money which can be raised.... The scheme is bound to come to an end sooner or later. When it does most of its members will have lost their money. This is not merely likely; it is a mathematical certainty. It is as certain as... that the organisers... will have made a substantial profit. The scheme is merely a device for enabling the organisers and a relatively small number of early recruits to

make... very large profits at the expense of the much larger number of those who are recruited later....

Schemes of this kind are inherently objectionable...."

25. One characteristic of this artificial market was that at each layer the brokers who arranged the reinsurances took 10-15% or more out in fees. "This... progressively reduced the amount of premium... available to pay the losses [claims] and enriched the... brokers by `churning' [fees] on each successive trade." [7(ix)]. The result was that "a very substantial part of the premium" was cumulatively churned out in such fees (instead of staying in the corpus of reserves to cover claims). [177(iii)] This made it even more of "...a mathematical certainty that the liabilities incurred by those participating... would far exceed the income... earned... [on] the premiums, particularly after commissions and brokerages had been taken by intermediaries who bore none of the risks. As the losses were passed on at each stage, there was less premium [left] to pay for them." [324(i)]

26. Another characteristic of this artificial market is that it was closely held among insiders. "Between these reinsurers and retrocessionaires in this... market there arose a **spiral** which entailed the losses being passed around between participants," analogous to the spirals in the catastrophe market "which had caused disastrous losses to Names at Lloyd's as a result of catastrophes in 1988-90" [7(x)].

27. The "pass the parcel" character of the closed artificial market facilitated the concealment of non-disclosure of its true nature over many years, and the postponement of realisation by its ultimate victims of that market's and their ultimate loss: "The spiral had a further advantage in that it deferred the losses for many years; when the losses eventually had to be paid by **some**one who could not recover from a reinsurer, there would have been such a lapse in time that those who had set the spiral up would no longer be around and so would not have to account for their actions." [253(vii)]

28. Unlike the catastrophe market, in which "there had been at least the prospect of profit in **some** years for those who might end up with the liabilities", in the workman's compensation ("WC carveout") market examined in Sphere Drake, "there were heavy **and certain** losses on an enormous scale which had to be paid year in year out." [7(x)]

This was exactly the case in Appellant's long-tail syndicates listed in Schedule H, which carried forward self-reinsured IBNR liability from prior years without building in **any** profit into the "reinsurance to close" ("RITC") premium passed to them from prior-year syndicates, in return for Respondent's syndicates assuming the risk from those prior-year syndicates so that the prior-year ones could close.

29. **Duty of disclosure not met** as to known loss: "[A]s long as proper disclosure [that the reinsurer would be writing at a loss] was made, there could be no complaint." [146, 257] "There was obviously a duty to disclose to any reinsurer, the fact that the business to be reinsured [onto] him was being written deliberately on the basis that the business would make a gross loss, with a loss ratio in some cases

of many hundreds of per cent (or more than 1,000%)...." [8, 291]

"If a participant enters [a] market [new to him] when he does not understand [its] risks..., he has no one but himself to blame if he makes... losses; he is presumed to know about the trade of the market in which he writes." [284] "However, it [was] obvious that the due diligence necessary was not easy for a person **outside** the market that traded in losses to implement.... It was by no means easy to see how a newcomer to this business could have obtained the necessary information, save by enquiry of an [insider] participant..." [290]

"It was... essential that any person committing his capital, whether as a Name on a syndicate at Lloyd's or as a company giving authority to an underwriting agent, was told of the nature of the business as it was so fundamentally different from conventional insurance...." [9]. "[T]he practises and characteristics of **this** market, particularly the deliberate writing of gross loss making business for no other purpose than to pass the loss to reinsurers, were so extraordinary that the fullest explanation of that market was necessary; reinsurers [n.b.: if so, a fortiori passive capital providers who were not London market reinsurers] were not to be presumed to know of such practices." [295]

Nevertheless, "I cannot accept that [even] a careful and prudent [active, professional] underwriter who did not regularly write in the London market would understand from the descriptions of the business given... or from the information provided... that they were accepting business which was being deliberately written to produce losses far in excess of the premium, and that they would be receiving through a spiral, not the **fortuity** of loss, but the **inevitability** of loss." [296] "[Even] to many [professionals active] **in** the [London] market [n.b. again, a fortiori to passive capital providers], it would never occur to them that there were others in the market who would write business in the knowledge that it would make a loss and thereafter pass those losses on to their reinsurers.... Such a practice would have been viewed by many... as contrary to the whole ethos and professionalism of conventional underwriting...." [298]

However, "those who wrote [that] gross loss making... business on the backs of reinsurers... **deliberately intended to pass enormous losses for as many years as they could** to reinsurers. A prudent and conventional reinsurer would not understand that any... honest insurer would **deliberately** write loss making business in order to pass it on to him; he would regard this as contrary to the whole ethos of the business and a breach of the duties of care and good faith." [299]

Because this practice would be counterintuitive to even an experienced but non-insider London market **professional** (a fortiori, to a passive capital provider), the duty of disclosure was especially pressing: "Clearly when someone was being offered business which appeared on its face to be conventional... but which in truth was... written deliberately in order to generate gross losses, particularly if it was spiral business [passing the parcel of liability among a closed group of insiders `in the know'], then... there was clearly a duty of the fullest disclosure." [303] The court's first conclusion was that "Deliberately writing business that is known will produce losses far

in excess of the premium on the basis that reinsurers will... pay for the losses..., is so alien to the ordinary practices of conventional insurance that it must be specifically disclosed." [336(i)]

30. No contemporary written documents explained to capital providers, however, the true way in which this insiders' market worked. [11] The documents provided "...were obviously insufficient to anyone who did not write business in [that] reinsurance market in London who did not know what the business actually involved." [303] In the only such document produced to the court, "the true nature of the business was deliberately and fraudulently concealed". [11(xi)] Such "grave dishonesty" had the effect that the "deception... induced insurers to become involved in a business in which they would never have been... if the business had been properly explained to them...." [22]

31. In particular, the court noted, "No report by managing agents of Lloyd's syndicates that participated in this business... set out the true nature of [it] so that the Names could appreciate the very grave risks quite different to conventional insurance and reinsurance..., though evidence was given that the nature of the business was explained to members' agents." [11(xii)] One lead syndicate's reports sent to Names "dishonestly concealed the nature... of this type of business by the syndicate and... the active underwriter, knew that the reports were seriously misleading." [11(xiii)] Appellant is prepared to show exactly the same at trial on a syndicate-by-syndicate analysis of the reports and accounts of his long-tail syndicates listed in Schedule H of the Particulars, and to show knowledge by Lloyd's (at the time of R&R, and of the claim) of such misleading and concealment.

32. **Duty of disclosure also not met as to insider transactions**: "There also had to be specific disclosure of any business of this type that had a spiral content". [8, 291, 336(i)] In Appellant's long-tail syndicates, it was worse than a spiral among a small group of at least nominally arms-length insiders: it was literally the same agent doing entirely internal **self**-"reinsurance" **with himself**, acting both as the buyer's agent on behalf of the prior year syndicate he managed and as the seller's agent on behalf of the current year one, his Names on which were assuming such certain loss from the prior-year one.

33. "The fact that there was no privity of contract between SD [the capital provider]... and the... underwriter [the managing agent, if at Lloyd's] did not mean that there could be no fiduciary duty: see **Powell & Thomas v Evan Jones & Co.** [1905] 1 KB 11. "As underwriter", the agents "were in a position to risk the capital of SD".... Given the extent of that authority and the circumstances of the appointment [which were that SD as capital provider was to be passive; the underwriter had been `given its pen'], the relationship was one that gave rise to... the highest degree of trust between SD and those who were authorised to underwrite [for it]." [42].

The SD court said "...the extent of those fiduciary duties was most clearly set out... [by] Millet LJ in **Bristol & West Building Society v Mothew** [1998] Ch 1 at 18....: `The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary.... A fiduciary... must

not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal...'" [48]

The court analogised the duty owed to SD [42] to, expressly, that fiduciary duty owed by the managing agents of Lloyd's syndicates to Names, even though their members agents had placed them onto those syndicates, and "There was therefore no contractual relationship [privity] between the active underwriter... or between the managing agent and the Names .... [I]t was decided in 1994 in **Henderson v Merrett** that a duty of care was owed in such circumstances,... a fiduciary duty." [43, also 44-45]. "The relationship between those entrusted with the underwriting [for] SD was, in my view, the same as that which existed in the Lloyd's market between the underwriter and the Names; **exactly the same considerations arise.**" [46]

34. Appellant has rehearsed Sphere Drake at such length in §§ 21-33 above because each individual point precisely characterises his long-tail syndicates listed at Schedule H of the Particulars, as shown to a threshold level on the evidence at skeleton § 3. If this was triable material in Sphere Drake, why not so in the present case? English insurance law imposes obligations on him as an underwriter; need it not reciprocally offer him the remedies available to one as well?

As to whether "manifest error" in quantum, error of law to have shut out triability of equitable set-offs? (Grounds issues I, X)

35. Several of Appellant's Part 18 questions (such as §§ 3, 4, and 9), and Grounds issue X (conscripted extra year of liability in violation of Lloyd's' own resignation rules as stated to this court in Bowman), raise issues that are not independent set-off but transaction set-off, "a complete or partial defeasance of" the claim. Aectra Refining and Manufacturing v Exmar [1994] 1 WLR 1634, at 1648-49 (Hoffman LJ), quoted in Glencore v Agros [1999] EWCA at para 19. It is as if those issues were ones of common law abatement under Mondel v Steel (1841) 8 M & W. 858, at 872 (Parke B), when a party "defend[s]... by showing how much less the subject matter of the action was worth", or of equitable set-off under Hanak v Green [1958] 2 QB 9, at 19 (Morris LJ), where the defendant pleads an equity which goes to impeaching title.

Hoffman LJ in Aectra observed that "a defendant should be entitled to rely upon the abatement or equitable set off in the plaintiff's action [not a separate cross-claim]"; "It would be quite unreasonable for the plaintiff... to confine the court to the facts which he chooses to prove and prevent it from examining related facts [in defence] as well" (at 1650B-C, quoted in Glencore at para 19), as happened in the Part 24 hearing by the court's deferring to § 5.5 of the R&R Contract. "There is all the difference between a claim and an equitable **defence**" Peter Gibson LJ observed in Filross v Midgeley [1998] EWCA Civ 1248 (2nd to last para, judgment); "it would be inequitable to take account of one without taking account of the other", citing Hanak v Green.

36. Appellant has run out of time to be able to develop this point, but notes that in common law abatement seems a matter of right, and that there is a presumption in favor of the availability of equitable set-off, albeit rebuttable by express terms in contract. The R&R Contract § 5.5 does not define "set-off". In the present case there are

particular issues of manifest **error** in discrete components of quantum, credits which Tropp's evidence suggests should have been subtracted to reduce quantum. Would these not lie triably as equitable set-off in defence under the policy of the law, to avoid unjust enrichment?

Denial of equitable set-off in defence (only) -- not distinguishing it from independent set-off for purposes of construing what is barred under § 5.5 of the R&R Contract -- would seem to engage ECHR article 13 (right to availability of "effective" remedy), and perhaps article 1 ("deprivation of possessions": in substance, right to property).

Richard A. Tropp
Appellant/Defendant
28 October 2004