In the High Court of Justice **2002 Folio 848**

Queen's Bench Division

Commercial Court

between:

The Society of Lloyd's

Applicant/Claimant

- and -

Richard A. Tropp

Respondent/Defendant

Respondent's Part 3.4 Skeleton Argument

This is a skeleton argument in opposition to claimant Lloyd's' CPR 3.4 application notice of 7 June 2004 to strike out defendant Tropp's Counterclaim, which is at §§ 35-53 of his Defence and Counterclaim ("Defence") filed 14 May 2004. The Counterclaim relies on evidence in §§ 1-26, 28 and 30 of the Defence, and in and annexed to his other filings which are cited therein, including in particular his Part 24 answer witness statement ("Part 24 answer") of 27 April 2004.

For facts supporting this argument, Respondent relies on evidence stated in the Defence paras above, and cited therein from his Parts 24, 18, 31, and 11 filings. Please n.b. especially Defence §§ 19-22, and the evidence in and annexed to § 14 of his Part 24 answer and §§ 4-5 of his Part 31 statement of case of 24 February 2004....

What law is applicable to Lloyd's when considering counterclaim?

9. Applicant's Defence to Counterclaim at § 8 and strikeout witness statement at §§ 7-8 seek to refute Respondent's counterclaim § 39, in which he asked the court to enter a declaration that the statutory immunities in § 14 of the Lloyd's Act 1982 do not shield Lloyd's (nor its principals immunised under § 14(6)) from the counterclaim. Respondent's point was that since Lloyd's brought the claim as assignee from Equitas, the law applicable to Equitas, the assignor, should apply to Lloyd's in relation to this counterclaim which arises from Lloyd's' claim as assignee. That law, which would apply to Equitas, includes English companies law, the general common and statutory law of insurance and reinsurance, and the general law of agency.

10. In § 9 of its Particulars of Claim against Respondent, Lloyd's relies on an assignment to it from Equitas effected in the R&R Completion Agreement (evidenced by a Deed of Assignment at Schedule F annexed to the Particulars) as having created a right of action for Lloyd's as assignee, under which Lloyd's brought its claim.

(a) The court may be aware that 100% of R&R litigation proceeds from this court's decisions go to the Corporation of Lloyd's: none at all to Equitas to strengthen its reserves, zero for protecting insured policy-holders whose cover with Lloyd's syndicates was reinsured into Equitas in R&R. (For discussion and supporting evidence see Part 18 Request question 1; Part 18 reply witness statement of 23 April 2004,

§ 5(a)-(b); Tropp letter of 8 June 2004 to Part 24 judge requesting that he reconsider, § 17; and Tropp Part 18 letter of 27 July 2004 to Lloyd's on question 1 [§ 32 "Relevant Correspondence" in bundle]).

Lloyd's brought its claim as assignee against Tropp in the role of a "factor" -- not Lloyd's' core insurance business, not the activity authorised and immunised in the 1982 Act. Under the R&R Assignment, Lloyd's in effect bought the R&R "RITC Debts" from Equitas for 7½ pence on the pound in exchange for Lloyd's' capital contribution to Equitas. What the litigation is about in business terms is realising a windfall profit for the Corporation on that factoring transaction.

(b) It is hornbook law that an assignee succeeds to the **rights**, including rights of action in law, of its assignor. It must follow in the law of assignment, symmetrically, that (albeit granted, an assignee does not succeed to its assignor's liabilities, too, merely by an assignment of that assignor's assets) the <u>remedies</u> which would be available to a third party as against the assignor, in relation to the matter which had been assigned, then become available against the assignee as well in relation, in particular, to that matter assigned.

This counterclaim arises directly from Lloyd's' claim, which Lloyd's has stated to this court that it brings qua assignee under the R&R Assignment. If Equitas were bringing the claim itself, Respondent would have remedies in counterclaim under companies law and general insurance law, inter alia. If the law of assignment is to be applied with equity as to a third party affected by a particular assignment, it follows that the remedies in counterclaim which Respondent would have had as against Equitas, the assignor, have become, by reason of the assignment, remedies in counterclaim against Lloyd's as assignee.

(c) Applicant's Defence to Counterclaim states at the end of its § 8 that "... it is denied that Mr Tropp has any entitlement to the declaration referred to in paragraph 39 because Lloyd's' claim... was... brought by Lloyd's as legal assignee [from Equitas]...." Precisely; Respondent argues that this is **<u>why</u>** he arguably has such entitlement to a declaration as to remedies being available to him under English companies law (which applies to Equitas) and inter alia the general law of insurance and reinsurance, even were § 10(a) above not so.

11. In addition or in the alternative, § 10(a) above suggests that Lloyd's' acts in harvesting a factoring windfall for the Corporation itself arising from the R&R assignment, through the litigation, *is not insurance business covered under the 1982 Act*, ergo is not a matter to which the Act's § 14(3) immunities should reach on the face of the statute, do reach, or were statutorily intended to reach.

(a) The Part 24 court refused to order Lloyd's to answer Part 18 question 1, on an up to a £ 3.4 billion windfall to Lloyd's from collection of the surplus assigned to Lloyd's by Equitas over and above Lloyd's' security interest in the R&R Debts. The claim against Tropp was part of such surplus over this security interest, on the straight arithmetic from reporting in Equitas' regulatory filings with DTI and the New York State Department of Insurance. The Part 24 court deemed question 1 not relevant to Tropp's **defence**, as the R&R assignment was valid. This still leaves the question for counterclaim, however, of whether the windfall constitutes an unjust enrichment to the Corporation (not, n.b. please, to the Society), and whether if so, Tropp may in the counterclaim recover on his own behalf (his pro rata share only) or on behalf of all beneficiaries of the Equitas Trust, or both.

Respondent asks this court to consider whether in light of § 10(a) above, question 1 is, though deemed by the Part 24 court not relevant in defence, nonetheless relevant to **this** court's consideration of the counterclaim, and if yes, whether now to order Lloyd's to answer it.

12. In the alternative as to counterclaim § 39, if the court were to deny Tropp the declaration he requests -- that § 14 of the Lloyd's Act is inapposite to and does not shield Lloyd's from the counterclaim, since the matter in the counterclaim arises (on Lloyd's' own submission in the claim) from the R&R assignment, and therefore the law engaged in the counterclaim should be the law that would apply to Equitas rather than to Lloyd's -- Respondent pleads that such denial would engage, and arguably would be incompatible with, ECHR article 13 (right to availability of "effective" remedy) in combination with ECHR article 1 of protocol 1 ("deprivation of possessions", in substance, the right to property under the Strasbourg jurisprudence).

It cannot be compatible with ECHR art. 13, in relation to the protections of art. 1 prot. 1, that an assignee in English law can succeed from an assignor to a right of action against a third party and bring that action, but be immunised against the third party's symmetrically succeeding to those remedies in counterclaim (at least, if not in defence) that it would have had against the assignor before the assignment. This would be unjust to a level of unconscionability, of a Wednesbury unreasonableness, when considered against the policy of the law on providing due reciprocality of rights and remedies....

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17. Tropp's counterclaim is based not on hoary arguments going back to acts in the 1980s, but on new **syndicate-specific detailed analysis** of his major syndicates relied on in Lloyd's' Particulars, analysis supported by multiply corroborated fresh evidence which he produced (and had prepared to support at trial with witness testimony), that the court had never considered [§ 13(a)-(e) above]. This evidence not only shows that Lloyd's' statements to the court in Schedule H and ergo the allegations in § 10 et seq of the Particulars were untrue and wrong, but it also documents that Tropp's liability alleged from those syndicates **did not arise from "insurance business"** within the meaning of § 8 of Lloyd's Act 1982 (Defence § 19), **nor from "re-insurance"** as understood in the industry and by regulators (id § 20).

18. Other Lloyd's cases such as <u>Price</u> cited by the Part 24 court to support its refusal of trial -- cases in which other defendants had required the **court**'s help to produce evidence for their threshold showing of arguable error, without which help they had not been able to do so themselves -- are inapposite because (a) this case is distinguished from those cited by that court by Tropp's having submitted fresh evidence himself to offer a Part 3.4 threshold showing of reasonable grounds, and (b) the defence cases are not on point as a matter of law within the different legal context of counterclaim....

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21. Fresh disaggregated evidence was submitted by Respondent to the Part 24 court on the syndicates listed by Respondent in Schedule H of its Particulars of Claim (Part 24 answer § 14, "The nature of the losses of Tropp's **particular syndicates, considered against Lloyd's' core business model** to which he agreed"; Part 31 statement of case, §§ 4-5; Defence §§ 19-20). Further new evidence was cited (Defence §§ 20(a), (d)-(f)) but not submitted at the hearing, in anticipation of an opportunity at trial. What Respondent's evidence shows is that when analyzed at the business unit level, Applicant's claim is ultra vires not only of statutory authority, but also of Lloyd's' own basic business model and ergo of the contract between the parties, to a level of being arguably in root breach of their intent in the agreement (Part 24 answer §§ 12, 15(b), 16; Defence §§ 10(d), 22) [though Tropp does not, please note, seek rescission of contract here as a remedy].

22. The fresh evidence Respondent developed [§ 13(a)-(e) above] shows that the liability imputed to him by Applicant in Schedule H was not insurance business and **not true "reinsurance"** [Defence § 20 preface, §§ 20(g)-(i)], which was what he had agreed to do, on Lloyd's' own definition [n.b. id § 20(j); Part 24 answer § 6(b) and Schedule C-2]. -- and thus was particularly egregiously ultra vires Lloyd's' basic business model, therefore of the parties' intent in the contract.

23. ...[P]erversely, it is [Lloyd's] who have departed from what the court knows as Lloyd's' familiar business model in having brought the claim; **it is Respondent who is relying on** and is counterclaiming under that venerable model, of which Applicant was in breach by its act of bringing the claim ultra vires its own historical model....

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85. Respondent's evidence cited at § 13 above, 2nd para ("In Defence §§ 17-26, **n.b.**..."), § 13(d) and § 13(e), and the samples explained at § 13(a)-(c) to give the court a flavor of what this evidence shows, suggest that at best, the long-tail syndicates listed in Schedule H of Applicant's Particulars were "trading in losses" within the meaning of Sphere Drake v Euro International, Stirling Cooke Brown & Ors [2003] EWHC 1636 (Comm) at paras 7(viii) and 157(ii), without disclosure to their capital providers as held in that case to be required.

What Respondent's evidence shows is 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 Respondent, 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)).

Respondent's evidence also shows that the Corporation of Lloyd's, who now pursue him to bear IBNR future liability from such "trading in losses", held in Sphere Drake at para 22 to be "grave dishonesty" and "a chronicle of deception" absent ex ante disclosure, internally knew at the time of their claim (and well before) the true nature of the Schedule H liability which they have stated to the court is his.

Respondent's evidence will show that by its proceeding against him, the Corporation knowingly has in effect been "covering" (in the colloquial) for such undisclosed "trading in losses" and "churning" by particular listed syndicates' managing agents, who were before R&R also insiders at the Corporation officer and Council member level....

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<u>Rights of action under general law of insurance and reinsurance</u>

114. In his Part 24 skeleton argument, Respondent 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 [§ 85 above, here]). In respondent's capacity as a mostly inadvertent reinsurer, there are... perhaps counterclaims... under UK insurance law, which he reserves here."

115. Respondent further 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... counterclaims under [general]... insurance law, and in that capacity he... is not limited by the Lloyd's Acts. He reserves such... counterclaims under... insurance law."

116. At § 16 of his Part 24 skeleton, Respondent had referred to and relied on <u>Sphere Drake</u> precisely in a context of pleading triability when under threat of strikeout: "The CA in **Hughes** (at § 22) [cited at § 94 above, a 2004 EWCA case] quoted Lord Browne-Williamson in **Barrett** [also at § 94 above, 2001 HL] on when especially [the court should be loath to strike out]: \`"[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 for... the strike out."'.... (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....)"

§ 19 in Respondent's Defence and Counterclaim was entitled "**<u>Not \`insurance'</u>; 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 Defence pp. 7-10, and please review the evidence cited and described in them, as prologue to what follows on Respondent's causes of action in counterclaim under the general law of insurance.

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

117. "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).

118. Sphere Drake applied this model, contrasting "not the **fortuity** of loss, but the **inevitability** of loss" [296] in the WC carveout spiral that was before the court, and "genuine fortuity" in the catastrophe market versus "inevitable" losses in the WC market [174(ii)]. Inherent in the WC 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.

119. 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 hav e **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.

120. See Respondent'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 § 13 above 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 Respondent's years of account. Notwithstanding having been privy within the meaning of Manifest at the time of R&R, Lloyd's now claim and defend against him as if the liabilities truly had arisen in his years from "insurance business". Lloyd's knows better; they had the internal confidential sample evidence described at § 13(a)-(c) above long before he did.

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

121. 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, § 119 id above 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 inJones 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 id § 117 above at para 173, Pill LJ).

122. 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...[,] 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.

123. 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).

124. "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 § 122 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).

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

126. This is the more so when an 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).

127. The court expressly applied this standard to a Lloyd's placement: "...where... the lead underwriters were more familiar than the followers [with risks in a particular insurance market] and where one of the lead underwriters had access to greater sources of information, the reliance upon the leaders' subscription is self evident." (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 at § 126 above) and a strict duty of disclosure to professional underwriters in the Lloyd's market who are "followers", then a fortiori, is there not the more so a presumption and an even stricter duty to passive Names who are certainly "follower" underwriters, but **not** professionals in the market?

128. The application of the duty of utmost good faith to insurance by Lord Mansfield in Carter v Boehm (§ 117 id above, at 1905) "was based upon the inequality of information as between the proposer and the underwriter..." (Pan Atlantic, Lord Mustill, quoted Manifest 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 at 58-59, Lord Hobhouse).

Marine Insurance Act 1906 § 17 codifies that "A contract of marine insurance [in common law, non-marine too] 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, but also of] claims. A dishonest claim constitutes a breach by the assured of section 17 and entitles the insurers to avoid [as to that claim]...." (Manifest at 81, Lord Scott).

129. After Manifest, "blind-eye knowledge", "deliberate refraining", "deliberate avoidance", "deliberate silence" arising from them, and related behaviors in §§ 121-25 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.

130. Lloyd's has claimed against Tropp for a next half-century's reserves to cover claims under the IBNR liabilities listed in Schedule H. Respondent invites the court to examine again his sample evidence explained at § 13(a)-(c) above, and to **please consider with care the schedules -- the sample raw evidence** -- cited in § 13(a) [tax filings made to government] and § 13(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 Respondent 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 see again § 13(d)-(e) above), suggest the applicability of the law at §§ 121-29 above to Lloyd's' statements to Tropp and to the court about those particular syndicates? If so, is that not a question triable on his fresh evidence under the law above, as to whether such syndicate-specific liabilities were ultra vires statutory authority and, a separate issue, ultra vires the intent of the parties in the agreement? Should not Respondent be able to try these issues in order to seek, under Manifest, to avoid particular Schedule H claims and to recapture refunds where an accounting shows them to be warranted?

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

131. The closest fact matrix analogy in the insurance law authorities to what Respondent's evidence (in § 13 above) shows is Sphere Drake (§ 85 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 Respondent'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?

132. 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.

133. The agents who wrote such business "did so on the basis that they had outwards reinsurance" which would cover the liability they had assumed for their capital providers; "They were... 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 [was]... 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 [only] 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...." [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)]

134. The underwriting managing agents were able to do this by, the court found, victimising "**innocent capacity**" [section head 2(8)(j)]: "...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 ignorant 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 were not] appreciating 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)].

135. "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 <u>Scott v Brown, Deering, McNab & Co.</u> [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 <u>Re Senator Hanseatische</u> [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...."

136. 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)]

137. 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)].

138. 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 someone 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)]

139. 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 <u>Sphere Drake</u>, "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 Respondent's long-tail syndicates listed in Schedule H, which carried forward self-reinsured IBNR liability from prior years, but without building **any** profit into the "reinsurance to close" ("RITC") premium that was passed to them from prior-year syndicates in return for his later-year syndicates assuming their risk. The point was for the managing agent -- who was acting **for both simultaneously** of the prior-year buyer syndicates (assureds) and the later-year seller ones (reinsurers) -- to close the prior-year ones.

140. **Duty of disclosure not met** as to known loss: "[A]s long as pro-

per 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... 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 [again, a fortiori to passive capital providers], it would never occur to them that there were others... 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 not naturally occur 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)]

141. 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]

142. 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)]

Respondent is prepared to show exactly the same at trial on a syndicate-by-syndicate analysis 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.

143. **Duty of disclosure further 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 Tropp's long-tail syndicates, it was not even a spiral among a small group of nominally arms-length insiders: it was literally the same agent doing entirely <u>internal</u> **self**-"reinsurance" **with <u>himself</u>**, acting as buyer's agent for a prior year syndicate and as seller's agent for the current year one, his Names on which were assuming certain loss from the prior-year one.

144. "As underwriter", the agents "were in a position to risk the capital of SD".... [42] "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** [of duty owed]." [46]

145. Respondent has rehearsed <u>Sphere Drake</u> at such length in §§ 132-44 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 § 13 above. If this was triable material in <u>Sphere Drake</u>, should it not be so in the present case?

146. English insurance law imposes obligations, and regulatory vulnerabilities under FSMA 2000, onto Tropp as an insurance underwriter. He gladly accepted them. If he is to be subject to them, however, then must not the law in justice reciprocally offer him as well those

English remedies which would be available to any other underwriter?

Such reciprocality -- or its absence, if he were denied triability, notwithstanding the close analogy to a point of near-identity of his fact issues with a non-Lloyd's insurer such as Sphere Drake -- again engages ECHR art. 13 (availability of effective remedy) in conjunction with prot. 1 art. 1 (deprivation of possessions, the ECHR's substantive provision for protection of rights in property).

Non-triability of equitable set-offs even in counterclaim, *after* they had been denied in defence, would cut against longstanding law that set off is presumed (in equity) or is a matter of right

147. Several of Respondent's Part 18 questions (i.e. §§ 3, 4, and 9) ...raise issues not of 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 Civ 1731 at para 19. It is as if those issues were common law abatement under Mondel v Steel (1841) 8 M & W. 858, at 872 (Parke B), when one "defend[s]... by showing how much less the subject matter of the action was worth", or equitable set-off under Hanak v Green [1958] 2 QB 9, at 19 (Morris LJ), where a defendant pleads an equity which impeaches 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.... 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 as well" (at 1650B-C, quoted in Glencore at para 19). Nonetheless, that is what happened in the Part 24 hearing by the court's deferring to § 5.5 of the R&R Contract....

Richard A. Tropp
Respondent/Defendant
and Counterclaimant
30 October 2004

[end insurance law points excerpt]