IN THE HIGH COURT OF JUSTICE **Nos.1996/2042,2047,2055**

QUEENS BENCH DIVISION

COMMERCIAL COURT

B E T W E E N :

THE SOCIETY OF LLOYDS

Plaintiff

- and -

DAVID WALTER WILKINSON
DENNIS HUGH REGINALD LEIGHS
GEOFFREY LYON

Defendants

SKELETON ARGUMENT ON BEHALF OF THE DEFENDANTS

INTRODUCTION

1. This Skeleton Argument is served on behalf of the Defendants Wilkinson, Leighs and Lyon in opposition to the Order 14 proceedings issued against them by Lloyd's, as assignee, for payment of the amounts allegedly due from them under the Reinsurance Contract purportedly executed on their behalves pursuant to the recent R&R proposals and Equitas scheme implemented thereunder.

2. The Defendants rely upon affidavits from Wilkinson and Leighs, and an affidavit from Mr Freeman exhibiting an expert report

produced by Mr South. Lyon's position is dealt with in a separate affidavit from Mr Freeman.

3. This Skeleton has been produced before seeing the evidence proposed to be relied upon by Lloyd's at the hearing on 19th December 1996.

4. Given that the hearing on 19th December 1996 is to be confined to non-fraud issues (pursuant to directions given by Colman J on 15th November 1996), this Skeleton only deals with those issues and does not deal with the Defendants' fraud and fraud-related defences, which are to be dealt with (if necessary) at the second stage of these Order 14 proceedings.

5. In addition, as indicated to Lloyd's solicitors in correspondence, this Skeleton does not deal with the potential European Community law defence outlined in the Wilkinson and Leighs affidavits, which the Defendants have not been able to investigate fully in the time available (a copy of Epstein Grower's letter is attached to this Skeleton).

6. So far as Lyon is concerned, it has not been possible to produce an affidavit from him dealing with his individual position due to his ill-health, as Mr Freeman explains in his affidavit. He adopts the defences advanced by the other Defendants to the extent that he is able to do so. If and to the extent that his personal position becomes material for the purposes of the non-fraud defences, the Court will be invited if necessary to adjourn the Order 14 proceedings against him to that extent.

Background Facts

7. Lloyd's is the corporation responsible for regulating the Lloyd's market. It is incorporated under the Lloyd's Acts 1871 to 1982.

Objects of Lloyd's

8. The objects of Lloyd's are *inter alia*:

The advancement and protection of the interests of Members of the Society in connection with the business carried on by them as Members of the Society...;

the doing of all things incidental or conducive to the fulfilment of the objects of the Society. (Lloyd's Act 1911, s. 4)

Regulatory Function

9. The Council of Lloyd's was established by the Lloyd's Act 1982, s.3. Pursuant to s.6(1) the Council has the management and superintendence of the affairs of the Society, the power to regulate and direct the business of insurance at Lloyd's and exercise all the powers of the Society, but such powers must be exercised in accordance with and subject to the Lloyd's Acts 1871 to 1982 and the byelaws thereunder. By s. 6(2), the Council is empowered to:

> "(a) make such byelaws as may from time to time seem requisite or expedient for the proper and better execution of the Lloyd's Acts 1871 to 1982 and for the furtherance of the objects of the Society, including such byelaws as it thinks fit for any or all of the purposes specified in Schedule 2 to this Act; and
>
> (b) amend or revoke any byelaw made or deemed to have been made hereunder."

It follows that when exercising its powers, Lloyds must do so in accordance with its own objects to advance and protect the interests of its members in connection with their underwriting business.

HISTORICAL FAILURES

10. The Defendants contend that they were defrauded into joining or remaining members of Lloyd's and that Lloyd's has since at least the early 1980's been guilty of massive regulatory failures which have caused or contributed to the substantial losses they have suffered. Recent Court decisions have recognised the extent to which Names were the victims of widespread negligence and misfeasance (see eg Cresswell J in Lloyd's v Clementson (Unreported, 7.5.1996), at p12-13). In Napier v Kershaw (Unreported, 24.10.1996, CA), Hobhouse LJ summarised the position thus:

> "Prior to 1980 the profitability and lack of regulation of the market had led to practices by many of the professionals involved which did not have regard to their duties to their principals. In the 1980's the market ran into difficulties. There was a lack of capacity which lead to the imprudent involvement of Names new to the market. Business which had previously been profitable became

> unprofitable and questionable short-term and other devices were adopted in an attempt to preserve that profitability or at least postpone the disclosure of its passing." (p21)

The Defendants were victims of the short-term and questionable devices referred to by Hobhouse LJ, at the heart of which was the practice of wrongfully rolling over losses from the past, by way of the reinsurance to close ("RITC") mechanism, onto unsuspecting and unknowing Names on subsequent years of account (see eg. the decision of Cresswell J in Henderson v Merrett Unreported, 31.10.1995). The vast majority of the losses rolled forward in this way related to asbestos, pollution and other health hazard ("APH") liabilities arising from US casualty policies written many years previously. For the most part, it is in respect of those liabilities that these Defendants are now being called upon to pay a reinsurance premium under the Equitas scheme to which Lloyd's has purportedly mandated them against their will.

Reconstruction & Renewal/The Creation of Equitas

Byelaws

11. Schedule 2 Lloyd's Act 1982 sets out the purposes for which byelaws may be made.

Agents' Agreements

12. A Name may only underwrite insurance at Lloyd's through an agent (s. 8(2) Lloyd's Act 1982).

13. The Council is empowered to make byelaws to prescribe or regulate terms which are or are not to be included in agreements between underwriting agents and underwriting members (Schedule 2 (15) Lloyd's Act 1982).

Agency Agreements Byelaw

14. The Agency Agreements Byelaw (No. 8 of 1988) was enacted on 7 December 1988 to prescribe contractual terms on which Names were to appoint their underwriting agents for 1990 and subsequent years of account. Accordingly, a contract between a Name and his Members' Agent or Managing Agent must be in a standard form and its terms cannot be varied other than by byelaw.

15. No managing agent is permitted to underwrite insurance business or provide any other services as managing agent to a member save in pursuance of an agreement in terms of the standard Managing Agents' Agreement (Agency Agreements Byelaw, Schedule 3).

Appointment of the Substitute Agent

16. By Schedule 2 (18) Lloyd's Act 1982, the Council may make byelaws:

"for empowering the Council to nominate and appoint an underwriting agent (in this paragraph referred to as the "substitute agent") to act as agent or sub-agent for an underwriting member as to the whole or any part of his underwriting business in any case where such member has no underwriting member for the whole or any part of his underwriting business or where in the opinion of the Council -

(a) such appointment is in the interests of such member; or

(b) it is essential for the proper regulation of the business of insurance at Lloyd's;

and to give such directions to any underwriting agent already acting for such member as may be desirable in connection with the appointment of the substitute agent."

17. The Substitute Agents' Byelaw (No. 20 of 1983) as amended on 8 September 1983 and 6 December 1995 provides *inter alia* that the Council may, at is sole discretion, appoint a person to act as agent or substitute agent for any underwriting member of Lloyd's where

(a) such member has no underwriting agent for the whole or such part of his underwriting business; or

(b) where in the opinion of the Council:

(i) such appointment is in the interests of such member; or

(ii) it is essential for the proper regulation of the business of insurance at Lloyd's.

18. Further, the Council may give directions to any member of the Society "... concerning the underwriting business of any member of the Society or for the protection of any Lloyd's policy holder, the Society , any member of the Society..." (Substitute Agents Byelaw, clause 3)

Reconstruction and Renewal Byelaw

19. On 6 December 1995 Lloyd's passed the Reconstruction and Renewal Byelaw (No. 22 of 1995) (the "R&R Byelaw") which empowered the Council to prepare and carry into effect the Equitas scheme. By clause 4 of the R&R Byelaw, the Council could direct members to enter into reinsurance contracts with Equitas on such terms as specified by Equitas and could direct a member's underwriting agent to do so on behalf of the member or former member who was subject to liabilities to which the Equitas scheme related (clause 4(1) R&R Byelaw).

20. The R&R Byelaw enabled Lloyd's to require a Name or his underwriting agent (*including the Substitute Agent* within the meaning of the Substitute Agents' Byelaw (No. 20 of 1983)) to "execute all such deeds and documents and do all such acts and things as may appear to the Council to be desirable or expedient in connection with or for the purposes of any such contract of reinsurance [with Equitas]" (clause 4(1)(d)).

Reconstruction & Renewal, The Settlement Offer

21. In July 1996 Lloyd's published a Settlement Offer Document ("SOD") containing the Reconstruction and Renewal Plan which comprised a settlement offer and proposed reinsurance scheme.

22. Lloyd's offered Names a settlement in respect of certain Claims in respect of their 1992 and prior business (excluding life business) including any 1992 and prior year liabilities reinsured to close into the 1993 or later year of account.

23. The essence of the Settlement Agreement was a waiver of Claims by Lloyd's in return for a waiver of Claims by Names.

24. A Claim was defined as "a claim, potential claim, counterclaim claim by way of enforcement of judgement, award or order of any kind (including as to interest and costs), right of appeal, claim by way of contribution, right of set off, indemnity, cause of action, right or interest of any kind or nature whatsoever whether known or unknown, suspected or unsuspected, whether arising in contract, tort, equity, fraud, as a consequence of wilful, reckless or negligent conduct, or of any fiduciary, statutory, regulatory or other duty, or otherwise, howsoever and whenever

arising, and in whatever capacity and jurisdiction." (Settlement Agreement Schedule 1, pg.29)

Waiver of Claims by Lloyd's

25. In broad terms, provided a Name validly accepted the Settlement Offer and paid all amounts due from him in respect of his Finality Statement, Lloyd's agreed *inter alia* to:

(i) waive any Central Fund Debts of a Name in respect of 1992 and prior business;

(ii) waive any claim for costs it might have against an accepting name arising out of the litigation in The Society of Lloyd's v John Stewart Clemenston (1992) Folio 1820 LC.

26. Provided a Name satisfied all other obligations in respect of any other years of account:

(i) he would be free to cease to be a member of Lloyd's;

(ii) Lloyd's undertook to make no further claims against such Name in respect of such business.

(Settlement Agreement clause 3, pg.3-5)

Waiver of Claims by Names

27. The Offer was made in full and final settlement of any Claim a Name might have in respect of 1992 and prior business. Accordingly, a Name who accepted the Settlement Offer would waive such Claims against Lloyd's, Equitas, agents, agents' E&O insurers, auditors who contributed to the auditor settlement fund (a fund of £156m applied to the settlement of claims brought by Names against the contributing audit firms and other third parties), and Lloyd's brokers.

Equitas and the Non-Accepting Names

28. The Equitas Group was formed by Lloyd's for the purpose of reinsuring liabilities of Lloyd's syndicates in respect of 1992 and prior business (other than life business).

29. It was a condition precedent to the Settlement Agreement that Equitas had executed the Reinsurance Contract. (clause 2.1(c), pg.3)

30. Further, each Name accepting the terms of the Settlement Agreement agreed to take all necessary steps to facilitate the payment of his Equitas premium. (clause 4.1, pg.5)

31. However, notwithstanding the refusal by the Defendants to accept the R&R proposals and the Settlement Offer, Lloyd's has purported to make the Defendants party to the Reinsurance Contract as set out in paragraphs 33 to 34 below.

Resolution and Directions

32. On 3 September 1996 the Council appointed Additional Underwriting Agencies (No. 9) Limited ("AUA9") as substitute managing agent for members of syndicates and closed year syndicates for the 1992 and prior years of account in respect of the entire business of such syndicates and closed year business (with certain exceptions), and for members of syndicates for the 1993 or any later year of account in respect of their underwriting business relating to 1992 or prior business reinsured to close into 1993 or any later year of account (Resolutions and Directions, para. A).

33. The Council purported to:

(i) direct AUA9 *inter alia* to execute the Reinsurance Contract for itself and on behalf of members (para. 1(iv));

(ii) direct each member not to interfere with AUA9 in the performance of its powers and duties and to "execute or concur in the execution of all contracts, deeds, assignments, mandates or other forms of authority or other documents reasonably required by or on behalf of the Substitute Agent, including giving effect to the Reinsurance Contract and any other agreement entered into in connection with or contemplated by the Reconstruction and Renewal proposals (para. 3).

The Reinsurance Contract

34. On 3 September 1996, AUA9 acting for itself and purportedly as Substitute Agent on behalf of Names, executed the Reinsurance Contract.

35. Lloyds has thus purported to impose the terms of the Reinsurance Contract on the Defendants who were not parties thereto and did not accept the terms of the Settlement Offer.

ORDER 14 PRINCIPLES

36. The basic test for obtaining leave to defend is whether the Defendants have established that there is a triable issue or some other reason for a trial. They submit that test is satisfied on the basis of the affidavit evidence filed by them.

37. The Court of Appeal has repeatedly stated that Order 14 is for clear and straight-forward cases only (British & Commonwealth v Quadrex [1989] QB 842 at p867-8 per Sir Nicolas Browne-Wilkinson V-C; Home and Continental Insurance v Mentor Insurance [1990] 1 WLR 153 at p158 per Parker LJ; Balli Trading v Afalona Shipping [1993] 1 Lloyd's Rep 1 at p9-10 per Beldam and Nourse LJJ; Notes to SCP, para 14/1/1 and 14/3-4/8). This is demonstrably not such a case.

LACK OF AUTHORITY

38. Paragraph 6 of the Points of Claim pleads that pursuant to the relevant byelaws Additional Underwriting Agencies (No. 9) Limited ("AUA9") was appointed as substitute managing agent for each of the Defendants for (effectively) all their syndicates with AUA9 being directed by the Council to execute the Equitas Reinsurance Contract. Paragraph 7 pleads that on 3 September 1996 AUA9 entered into the Reinsurance Contract on behalf of the Defendants, with para 9 claiming the premium due as assigned (para 10) to Lloyd's.

39. The Defendants rely on the fact that they had expressly withdrawn their managing agents' authority to commit them in any way to Equitas: Wilkinson affidavit paras 43-45, and Leighs' affidavit paras 80-83.

40. The Defendants rely on Article 122 in *Bowstead & Reynolds on* Agency (16th End.), p.673:

> "Subject to the provisions of Articles 120 and 124, the authority of an agent, whether conferred by deed or not, and whether expressed to be irrevocable or not, is terminated by the principal giving to the agent notice of revocation at any time before the

authority has been completely exercised ... without prejudice to any claims for damages that the principal or agents may have against the other for breach of any contract between them"

41. As explained in the Comment at para **10-021** (para 673), the rule was based on policy and applies:

"without prejudice to the fact that such revocation may be wrongful as between principal and agent .... There is a power to revoke: but there is not necessarily a privilege to exercise the power - there may indeed be a duty not to do so, with the result that the revocation is a breach of contract...."

42. AUA9 was substituted for the Defendants' existing managing agents and "stood in their shoes " so far as the managing agent's authority was concerned. See in this regard clause 10.2 of the standard Managing Agent's Agreement ("in place of Agent"). Moreover, AUA9 as the "creature" of Lloyd's had the latter's knowledge of the withdrawal by the Defendants of their managing agents' authority.

43. The rule is supported by ancient authority: *Vynior's Case* (1609) 8 Co. Rep. 81b at 82a:

"or if I make one my factor; or if I submit myself to an arbitrament; although these are made by express words

irrevocable, or that I grant or am bound that all these shall stand irrevocably, yet they may be revoked"

44. Article 122 is subject to the rules as to irrevocable authority discussed in Article 120 of *Bowstead*, p.660:

"(1) Where the authority of an agent is given by deed, or for valuable consideration, for the purpose of effectuating any security, or of protecting or securing an interest of the agent, it is irrevocable during the subsistence of such security or interest. But authority is not irrevocable merely because the agent would be prejudiced by its revocation, or has a special property in, or lien for advances upon, the subject-matter of it, the authority not being given expressly for the purpose of securing such interest or advances."

45. This is explained in para **10-007** (p. 661) as follows:

"Authority can be irrevocable; but this is only where the notion of agency is employed as a legal device for a different purpose from that of normal agency, to confer a property or security interest on the "agent" .... Authority is normally only irrevocable where it *is* the security or proprietary interest, or a part of it or means of achieving it, or where it secures an obligation owed by principal to agent."

46. The limitations on this exception are apparent from a number of authorities, including *Smart & Others -v- Sandars & Others* (1848) 5 C.B. 895: see Wilde C.J. at 917/8:

"and the result appears to be, that, where an agreement is entered into on a sufficient consideration, whereby an authority is given for the purpose of securing some benefit to the donee of the authority, such an authority is irrevocable. This is what is usually meant by an authority with an interest, and which is commonly said to be irrevocable.

"But we think this doctrine applies only to cases where the authority is given for the purpose of being a security, or, as Lord *Kenyon* expresses it, as a part of the security; not to cases where the authority is given independently, and the interests of the donee or authority arises afterwards, and incidentally only."

47. The authority which the Defendants granted to their managing agents by clause 5(a) and (c) of the standard Managing Agents' Agreement was not as part of any security: hence it was open to the Defendants to withdraw their managing agents' authority to re-insure through Equitas - even if they were thereby in breach or repudiation of their Agreements with their respective managing agents.

48. Furthermore, their managing agents' paramount duty was to act in the interests of the Defendants: clause 4.2(b).

49. In any event, the Defendants will contend that clause 7.3, as a matter of construction is not to be regarded as analogous to an irrevocable power of attorney; it only relates to day-to-day management and control of the Defendants' underwriting. In

other words, a radical change in the management and re-insurance of the Defendants' pre-1992 open, and indeed closed, years through Equitas (which was obviously quite outside the contemplation of the parties when the Managing Agent's Agreements were signed) must be regarded as outside the scope of clause 7.3, or indeed any other provision of the Managing Agent Agreement.

THE VALIDITY OF THE EQUITAS SCHEME

Outside Scope of Venture

50. The implementation of the Equitas scheme pursuant to the R&R proposals has fundamentally altered the Lloyd's market and the manner in which that market manages its 1992 and prior business.

51. When Names joined Lloyd's, they agreed to abide by the rules of the Society they were joining, by executing the General Undertaking. Although those rules included s6(2) of the Lloyd's Act which gave the Council power to make and amend or revoke byelaws, there were certain matters which were fundamental to

the nature of the underwriting business embarked upon by Names when they joined the Society. These included the following:

(1) the principle of several liability, enshrined in s8 of the Lloyd's Act 1982 and described by Saville J in Lloyd's v Clementson (Unreported, 16.12.1993) as having "always been a fundamental principle of underwriting at Lloyd's" (p1-2);

(2) the principle that Names' affairs are managed by underwriting agents who owed obligations of due care and skill, and fiduciary obligations, to the Names. As Steyn LJ said in Lloyd's v Clementson [1995] CCH CLC 117, "the Lloyd's system operates on the fundamental premise that a Name entrusts his affairs, and in the process his fortune, to his managing agents: The Name has remedies both in contract and tort against the managing agent" (p132);

(3) the three year accounting and RITC mechanism, whereby a year of account was closed at the end of its third year, by way of an RITC into the succeeding year of account in return for the payment of a premium, except where the

outstanding liabilities of the year of account could not be estimated with a reasonable degree of accuracy, in which case the year of account was required to be left open. As Cresswell J said in Henderson v Merrett (Unreported, 31.10.1995), it was "fundamentally wrong" to seek to close a year of account where the amount to be charged by way of premium in respect of the RITC could not be arrived at with a reasonable degree of accuracy (p119-120);

(4) the rigorous auditing of Names' liabilities by the Lloyd's audit, covering inter alia the determination of the premium for the RITC. As the "Lloyd's of London" book published by Lloyd's (read by Wilkinson - see para 9 of his affidavit) stated: "To exaggerate the importance to Lloyd's of the underwriting audit is impossible ... it is the keystone round which the structure of Lloyd's security is now built".

52. The brochures issued by Lloyd's itself, which were given to Wilkinson and Leighs prior to their joining Lloyd's, emphasised these fundamental aspects of conducting business at Lloyd's: see

esp. para 2.6 to 2.7, 2.9 and 10 to 12 ("DWW1"-5 to 6 and 12 to 13).

53. Names reasonably expected that these fundamental tenets would not be altered, and especially would not be altered to their detriment without their express consent. Wilkinson and Leighs understood these matters and proceeded to join Lloyd's on the basis of their understanding (Wilkinson para 7-12; Leighs para 21-4).

54. The Council's power to make and amend or revoke byelaws did not empower them to alter the fundamental nature of the business and risks assumed by Names when they joined Lloyd's. The exercise of that power was subject to at least the following limitations:

(1) The power could only be exercised for the purposes for which it was conferred and not for any extraneous or ulterior purpose (Re Courage Groups Pension Schemes [1987] 1 WLR 495 at p505 per Millet J). Those purposes are in this case to be derived from the Lloyd's Acts, construed in the context in which the market has operated;

(2) The Council's power to make and amend or revoke byelaws was given to it in order to enable it to carry out its responsibility of managing and superintending the affairs of the Society and regulating and directing the business of insurance at Lloyd's (s6(1) of the 1982 Act), but always in the context of the nature of the underwriting venture embarked upon by Names when they joined Lloyd's. The purpose of the power was not to enable the Council fundamentally to alter the basis on which Names' underwriting businesses were conducted or run-off;

(3) The Council's power could not be used to bind members against their will on matters outside the contemplated scope of the venture upon which they embarked when they became Names at Lloyd's. This is plain from Hole v Garnsey [1930] AC 472 and Napier v Kershaw (Unreported, CA, 24.10.1996). The relevant principles were clearly stated in Hole v Garnsey:

> "If a man enters into association with others for a business venture he commits himself to be bound by the decision of the majority of his associates on matters within the contemplated scope of the venture. But outside the scope

he remains dominus, and cannot be bound against his will." (p493 per Lord Atkin)

"In construing such a power as this, it must, I think, be confined to such amendments as can reasonably be considered to have been within the contemplation of the parties when the contract was made, having regard to the nature and circumstances of the contract. I do not base this conclusion upon any narrow construction of the word "amend" in Rule 64, but upon a broad general principle applicable to all such powers." (p500 per Lord Tomlin)

55. A purported exercise of power in contravention of these principles would not be binding upon those members of the Society who had not expressly assented to that exercise of power (Hole v Garnsey, at p496 per Lord Atkin).

56. Each of the four fundamental tenets outlined in paragraph 51 above has been substantially changed by the Equitas scheme. If effective and binding upon these Defendants (notwithstanding their dissent), the Equitas scheme would result in their underwriting business being conducted and run-off in a manner which is fundamentally different to that contemplated by them (or other Names) as being within the scope of their venture. In essence, management and control of the Defendants' underwriting business has been removed from their personal agents (who were accountable to them) and taken over by Lloyd's.

57. In particular:

(1) All Names' 1992 and prior underwriting business and related Lloyd's affairs have been removed from the control and management of managing or run-off agents, separately appointed or selected for each syndicate, and transferred to AUA9, which is a creature of Lloyd's under the control and direction of the Council (p12 of Appendix 7 to SOD), and/or to Equitas Reinsurance Ltd ("ERL");

(2) In particular, control of the conduct of the run-off of each of the Defendants' open year syndicates has been removed from their personal managing or other run-off agents and transferred to ERL, which has responsibility for the run-off of the entire Lloyd's market's 1992 and prior liabilities (clause 3(b) of the Managing Agent Agreement; contrast clause 9.1 and 9.2 of the Reinsurance Contract). Instead of that run-off being conducted on a syndicate by syndicate basis it is now to be conducted on a global market-wide basis;

(3) It follows that the function of settling and paying claims for the Defendants has also been removed from their personal managing or other run-off agents and transferred to ERL (clause 3(e) of the Managing Agent Agreement; contrast clause 9.2(a) of the Reinsurance Contract). This is notwithstanding the numerous conflicts of interest that will inevitably now arise in running-off the Names' 1992 and prior business and collecting or disputing reinsurance recoveries in relation to that business, as referred to by Mr South in para 91 to 104 of his report;

(4) Previously the policy in relation to reinsurance for and closure of the Defendants' syndicate years of account was the responsibility of their personal managing or run-off agents (clause 3(d) of the Managing Agent Agreement), whereas under the Equitas scheme, the terms on which each of the Defendants' syndicates were reinsured into ERL were determined by Lloyd's in conjunction with Reserve Group (which was established by Lloyds: see SOD, p68). Those terms were mandatory and *imposed* upon the Defendants' managing and run-off agents (as

those agents admitted in their respective syndicate accounts - see eg "DHRL1"-109);

(5) Contrary to the position prevailing in the market prior to Equitas, a single body, ERL, is now responsible for both running-off and reinsuring the Names' 1992 and prior liabilities;

(6) Despite assertions by Lloyd's and agents that the Equitas premium is an RITC (see p6-7 of SOD and syndicate accounts at "DHRL1"-109), the protections previously afforded to Names when an RITC was being fixed have not applied to the determination of the Equitas premium:

(i) A premium was fixed for the reinsurance of Defendants' open years into ERL despite the fact that their personal managing and run-off agents had determined at 31 December 1994 that the outstanding liabilities on those years of account could not be determined with any or any reasonable degree of accuracy and therefore could not be closed (especially because of their exposure to

incalculable APH liabilities) (see Wilkinson para 41(4) and Leighs para 85(d)). The Equitas scheme thus breaches the cardinal principle underlying the RITC mechanism, namely that a premium for an RITC will not be forced upon Names where their outstanding liabilities cannot be estimated with a reasonable degree of accuracy such that equity cannot be achieved between them and their proposed reinsurers (see para 4 of Schedule 3 to the Syndicate Accounting Byelaw and p119-120 of the Merrett Judgment);

(ii) The premium fixed for the Equitas premium was calculated not by the Defendants' personal managing and run-off agents but by Lloyd's in conjunction with the Reserve Group and imposed upon the Defendants personal managing and run-off agents. At least two of Wilkinson's managing agents were unhappy with the premium foisted upon them, which were not verifiable and would not have been accepted in other circumstances: see South report, para 60. Notwithstanding their agents'

disapproval and the fact that the determination of the premium for the RITC was one of the most critical exercises performed by the managing agent for his Names, the Defendants purportedly are obliged to accept and pay the amounts dictated to them by Lloyd's;

(iii) The Equitas premium figures were expressly exempted from any auditory review, despite the obvious importance of those figures to all Names. Syndicate auditors were not required to, and did not, express any opinion on the Equitas premium, the value of the Names' reserves transferred to ERL or the results of syndicates following reinsurance into Equitas (Wilkinson para 42(2)). By contrast, it was previously fundamental that where a year of account was closed by way of an RITC, syndicate auditors were required to satisfy themselves that the premium for the RITC was equitable as between the reinsured and reinsuring Names and report accordingly to the Names of the syndicate

concerned (Merrett Judgment, p120-125; para 12(a) and (c) of the Syndicate Accounting Byelaw);

(iv) A general IBNR provision of £900 million was imposed across the board to all syndicates in a manner which was arbitrary and bore little if any correlation to individual syndicate's actual future outstanding liabilities (see SOD p79; South Report, para 114 and para 73 to 86);

(7) Equitas fundamentally altered the several nature of the Defendants' underwriting business. Until Equitas, reserves had been established by the Defendants' managing agents, on a syndicate by syndicate basis, to meet their outstanding liabilities. The entirety of those reserves have now been transferred to ERL, at values determined by Lloyd's and ERL (not the managing agents) and which have not been reviewed or audited by syndicate auditors (see Wilkinson para 42(2); the transfer of Names' reserves is dealt with by clauses 3.1(c) and (d), 5.1(d) and 6.1 of the Reinsurance Contract). Those reserves are now held on a market-wide basis. They are pooled within ERL and are

available to meet not only the Defendants' liabilities but also the liabilities of the entire rest of the market - mutualisation in effect. The Defendants' reserves might well be used up by claims on other Names and other syndicates, leaving insufficient resources with which to meet the Defendants' own liabilities (see p144 of SOD). The syndicates most likely to be prejudiced are those with long-tail liabilities, which may not fall to be paid for many years to come - including many of the Defendants' open year syndicates (see Wilkinson para 31);

(8) In addition, the Equitas Scheme involved the mandatory reinsurance not only of the Defendants' open years, but also of other years of account which had previously been closed by way of an RITC in the usual way (which at the time had been approved by the Defendants' managing agents and audited and approved by their syndicate auditors).

58. In order to attempt to procure the many changes made by the R&R proposals and Equitas scheme were effective notwithstanding their inconsistency with numerous other byelaws

which had formed the basis upon which the market had previously operated, the R&R Byelaw purported to provide (in para 14) that it was to have effect notwithstanding any such inconsistencies. This demonstrates the extent of the fundamental changes brought about by the Equitas scheme.

59. All these fundamental changes have purportedly been forced on the Defendants, against their will, pursuant to the R&R Byelaw. Those changes have altered the basic nature of the Defendants' business at Lloyd's and were not within the reasonable contemplation of the parties when they joined Lloyd's. The changes introduced are altogether outside the scope of the venture embarked upon by either Defendants when they joined Lloyd's and cannot bind them without their consent, which they have not given (Hole v Garnsey, at p496 per Lord Atkin).

Unreasonableness

60. To be valid, a byelaw must be reasonable (Wade and Forsyth, Administrative Law, 7th edn, p878-881; Halsbury Laws of England, Vol 28, para 1330; Kruse v Johnson [1898] 2 QB 91). This principle applies to public law bodies such as local

authorities; the Defendants say that *a fortiori* they apply to Lloyd's. It is in any event common ground that the Council has a duty to act both in good faith and reasonably when exercising its powers to make and amend or revoke byelaws (SOD at p8; see also R v Council of Lloyd's ex parte Johnson, Unreported, 16.8.1996, per Brooke LJ at p84-5, referring to advice given to Lloyd's by Freshfields and leading counsel as summarised in the Slaughter and May report to the Validation Committee).

61. The R&R Byelaw does not meet the requirement of reasonableness, for the following reasons:

(1) The byelaw purports to force upon all Names (irrespective of their consent) a scheme which is outside the scope of the venture contemplated by Names when they became members of Lloyd's, for the reasons given above;

(2) The Equitas premium fixed is arbitrary in amount:

(i) it purports to fix a premium for liabilities which managing agents and syndicate auditors agreed at

31st December 1994 were unquantifiable (Wilkinson para 41(4));

(ii) the general IBNR provision of £900m applied across the board to all syndicates bore no necessary correlation to outstanding liabilities and could not be justified on any rational basis (South Report, para 81-5 and 114);

(iii) the "releases" were arbitrary and unjustifiable (South Report, para 58);

(iv) there was no rational basis for the additional premiums levied by Equitas (South Report, para 58 to 64);

(v) no adequate account was, or could in the time available have been, taken of the true extent of the liabilities of Names on PSL syndicates (Wilkinson para 41(7) and 42(3));

(3) No actuarial verification of the premium has been provided: Tillinghast were unable to provide any confirmation for Names that the provision for outstanding 1992 and prior liabilities was reasonable (letter in Appendix 4 to SOD);

(4) The incidence of the cost of the Equitas premium is arbitrary and unfair, the methodology adopted by Equitas favouring syndicates still underwriting over syndicates which had ceased to trade (as had all the Defendants' syndicates) (South Report, para 105-108);

(5) Equitas is intended by Lloyd's to reinsure Lloyd's own liabilities under Lioncover, notwithstanding:

(i) the inherent impossibility of attempting to ascertain the true extent of the outstanding liabilities of the former PCW syndicates, not only because of their substantial exposure to APH liabilities but also because of the extreme difficulties involved in ascertaining the extent to which recoveries can be made under the complex reinsurance programmes

purportedly put in place by those syndicates (see SOD esp at p78 and South report at para 93 to 104); and

(ii) the conflicts of interest involved in Lloyd's effectively setting the premium for Equitas covering its own liabilities (cf South Report, ibid)

(6) No external quotes were sought or obtained by Lloyd's for any part of the market's 1992 and prior liabilities;

(7) The premium has not been shown, whether by Lloyd's or otherwise, to be fair or fairly assessed, and cannot be shown to be such. Lloyd's has denied Names access to the underlying data and refused to provide any further information, beyond that given in syndicate accounts or SOD, when asked (as Wilkinson did: see para 50 of his affidavit and "DWW1"-109 to 110).

62. The R&R Byelaw, and hence the Equitas Scheme implemented pursuant to it, are void and of no effect against these Defendants. The purported execution of the Reinsurance Contract on their behalves was a nullity. They are thus not parties to that Contract

and are not liable to pay any premium demanded thereunder, whether by way of assignment or otherwise.

CONFLICT OF INTEREST

63. The relationship between Lloyd's and the Defendants is both contractual (through the General Undertaking) and as regulator of this important sector of the UK insurance market, with regulatory duties which might conflict with the contractual and fiduciary duties which it owes to the Defendants and other names: see the Law Commission's Consultation Papers No. 124 (1992) pp.51 & 193. (We accept that there is a line of Divisional Court authority in judicial review applications, which has held that Lloyd's is for certain purposes not a public body exercising regulatory functions, most recently *R v Lloyd's exp. Susan Rachel Johnson & Ors*, unreported 16.8.95). The relationship between the Defendants and their managing agents is contractual, with the agency relationship giving rise to fiduciary duties in equity and by the express terms of clause 4.2 (b). These fiduciary duties of the managing agents are crucial in the context of this defence: the more controversial duties of Lloyd's are secondary.

64. Where there is a potential conflict between the interests of the managing agent and the Names, clause 4.2 (d) provides a duty of full disclosure, and clause 4.3 (a) will only permit the managing agent to act where there is a conflict, if the conflicting interest has been fully disclosed in writing, and on the basis that the Name "has agreed that the agent may continue to act for him despite that interest".

65. The paramount duty on a fiduciary (i.e any managing agent and Lloyd's itself) not to allow its interests to conflict with those of a Name is apparent from ***Phipps -v- Boardman*** [1967] 2 AC 46, Lord Upjohn at 123D. See also Article 46 of *Bowstead* and the discussion at paras **6-057** and **6-060**. See also *Chitty on Contracts, Specific Contracts (27th edn.)* para **31-109**. We also rely on ***Yasuda Fire & Marine -v- Orion Marine Insurance*** The Times 27.10.94, where Colman J. held that the fiduciary relationship between parties to an underwriting agency agreement was independent of the contract.

66. If an agent enters into an agreement with, or on behalf of, his principal in circumstances of conflicting interests then in the absence of full disclosure and informed consent, or subsequent

waiver with the benefit of informed consent the transaction is voidable at the instance of the principal, whatever the *bona fides* of the agent or the fairness and advantage to the principal of the transaction.

67. These principles appear in *Chitty* at para 31-109 (p.72) and are supported by the authorities in the footnotes, including:

Aberdeen Railway -v- Blaikie Bros. (1854) 2 Eq. Rep. 1281 H.L. *per* L.C. at 1286:

> "So strictly is this principle adhered to, that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into" ... It may sometimes happen that the terms of which a trustee has dealt or attempted to deal with the estate or interests of those for whom he is trustee have been as good as could have been obtained from any other person; they may even at the time have been better; but still, so inflexible is the rule, that no inquiry upon that subject is permitted."

Transvaal Lands Co -v- New Belgium [1914] 2 Ch. 488 *per* Swinfen Eady L.J. at 502, who explains that, although *Aberdeen -v- Blaikie* was a Scottish case, it was held in that case that there was no difference between Scottish law and English law. The general rule is reiterated at the bottom of p.504, and it is clear from p. 505 that the strict requirements of any contractual

provision modifying the equitable rule (in that case, the company's articles) have to be strictly complied with.

Phipps -v- Boardman The fact that the agent acted in good faith was held to be irrelevant, as appears from Lord Cohen at 104E-F, Lord Hodson at 105G, Lord Guest at 115C-D and Lord Upjohn at 123B-C.

68. The evidence regarding conflict of interests is dealt with in para 53 of Wilkinson's affidavit, and para 96 of Leighs's affidavit. They rely generally on the advantage to Lloyd's (effectively representing those Names who continue to underwrite) in ensuring that all the pre-1992 Names - including the Defendants - are contracted into Equitas. By the use of AUA9 Lloyd's was effectively making itself the Defendants' substituted managing agent, and as such the potential conflict between the interests of Lloyd's and those of the Defendants have to be considered. The Defendants also rely specifically on the one-sided provisions of clause 5.5. (no set-off) and clause 5.8 (regarding the giving of notice of assignment to AUA9). Both of these provisions are incidental to the general Equitas scheme, and if fairness or reasonableness were relevant we would submit that they were

unnecessary, unfair and unreasonable in the context of the minority of Names who have not accepted R & R. (Their issue would be irrelevant to the great majority of Names who have accepted R & R.)

69. Clause 5.5. of the Reinsurance Contract was drafted in circumstances where the immediate assignment to Lloyd's was contemplated, and with Lloyd's fully appreciating that any Name who would be rejecting R & R was likely to be contemplating proceedings to which the 'no set-off' provisions of clause 5.5 would apply.

70. In the context of clause 5.8, if notice of the assignment was in fact given to AUA9, that would have been in circumstances where it was known that AUA9 would not be passing on that receipt of notice to the Defendants and the other Names in question. It was commercially unnecessary, and indeed unjustifiable, to provide for notice of assignment to be given to a purportedly substituted managing agent (AUA9) which was a "creature" of Lloyd's in circumstances where Lloyd's had no intention of ensuring that AUA9 communicated that notice to the Defendants and the other Names.

71. The passing on of any notice of assignment received by AUA9 represented a duty within clause 4.2 (a) of the Managing Agent's Agreement, and would have been in the interest of the Defendants within clause 4.2 (b). The inclusion of clause 5.8 in circumstances where Lloyd's knew that AUA9 would, in breach of that duty, not pass on forthwith to the Defendants a copy of the notice of assignment, represented a clear instance of a contractual provision which favoured the interests of Lloyd's and, if relevant, of AUA9 - over those of the Defendants.

72. It is apparent from para 6 (3) of the Points of Claim that Lloyd's does not pretend that AUA9 exercised any independent judgment in purportedly executing the Reinsurance Contract of behalf of the Defendants. There was therefore no prospect of AUA9 exercising its duties under clause 4.2 (a), (b) and (d). Constitutionally AUA9 was merely a technical device whereby Lloyd's *de facto* executed the Reinsurance Contract purportedly on behalf of the Defendants: see para 49 (2) of Wilkinson's affidavit and para 93 (b) of Leighs's (and exhibited company search documents). The premeditated use of AUA9 is apparent from Appendix 5, Section J (pp. 11-12) of SOD.

THE VALIDITY OF THE APPOINTMENT OF AUA9

73. The Council appointed AUA9 as substitute managing agent for the Names in respect of their 1992 syndicates and 1992 and prior business (as defined in the Reinsurance Contract). This appointment was made pursuant to para 1(b) of the Substitute Agents Byelaw ("SAB"), which empowers Lloyd's to appoint a substitute agent for a Name where in the opinion of the Council that was (i) in the interests of that Name or (ii) was essential for the proper regulation of the business of insurance at Lloyd's (see para (C) of the preamble to the Reinsurance Contract).

74. It is plain that when passsed, the SAB was not intended to deal with the appointment of a global substitute agent in the context of a market-wide ring-fencing exercise such as that involved in the Equitas scheme. It is submitted that properly construed, the SAB did not empower Lloyd's to appoint AUA9 as a substitute agent for the Defendants.

75. Neither of the limbs of the para 1(b) of the SAB was satisfied in the case of either Defendant:

(1) the appointment of AUA9 was not in the Defendants' interests because:

(i) they contend that they are entitled to rescission of their membership of Lloyd's for fraud and that they are not members of Lloyd's or otherwise bound as members of Lloyd's by Lloyd's Byelaws or directions issued by the Council pursuant to its powers thereunder;

(ii) the Equitas premium was arbitrary and unfair (for the reasons given above);

(iii) the Equitas premium has not been shown by Lloyd's to be fair or fairly assessed, and cannot be shown to be such;

(iv) the Equitas scheme was in any event outside the scope of the venture upon which they embarked (for the reasons given above);

(v) when recommending the R&R plan (involving the implementation of the Equitas scheme) to the membership of Lloyd's, the Council recognised that it may not be in the best interests of each Name; rather, it recommended the plan on the basis that it believed the plan was in the best interests of the Society "as a whole" (SOD, p8). The SAB requires, however, that the appointment of the substitute agent must be in the interests of each individual Name for whom the substitute agent is appointed. The appointment of a substitute agent under SAB cannot be justified on the basis that it was in the interests of the market as a whole, albeit not in the interest of the individual Name(s) affected by the appointment.

(2) the appointment of AUA9 was not essential for the regulation of the business of insurance at Lloyd's. AUA9 was appointed in order to give effect to the Equitas Scheme and the wider R&R proposals, which were put forward for essentially commercial purposes, namely to resolve Lloyd's problems of the past, to settle outstanding

litigation and, in so doing, to prepare a sound basis on which the future market might prosper (cf syndicate accounts at "DHRL1"-109). The R&R proposals and the Equitas scheme were not regulatory measures. Nor did they depend upon, or require, the appointment of a global substitute managing agent for all purposes, extending well beyond the execution of the Reinsurance Contract.

INVALIDITY OF THE ASSIGNMENT

76. The notice of the assignment to Lloyd's of ERL's rights to the Equitas premium, given by ERL to AUA9 on 2 October 1996, was invalid because AUA9 had no authority to accept any such notice on Defendants' behalf (for the reasons given above). Notice to AUA9 was in any event irrelevant because it constituted no more than notice to Lloyd's itself, which Lloyd's knew that AUA9 would not pass on to the Names (as in fact it did not).

77. The only notice of the assignment given to the Defendants was purportedly contained in Dibb Lupton's letter of 1 October 1996, which was premature, wrongly stating that the assignment had already been made, whereas it was only made the following day

("DWW1"-110A; Leighs ref). That notice was thus invalid and of no effect (Harrison v Burke [1956] 1 WLR 419 (CA)). As Denning LJ said in Harrison v Burke at p421:

> "It is only necessary to read section 136 of the Law of Property Act, 1925, to realise that the notice in writing of the assignment is an essential part of the transfer of title to the debt, and, as such, the requirements of the Act must be strictly complied with, and the notice itself, I think, must be strictly accurate - accurate in particular in regard to the date which is given for the assignment; and even though it is only one day out, as in this case, the notice of assignment is bad." (see also Morris LJ at p422)

78. Lloyd's thus has no claim against the Defendants as pleaded in the Points of Claim.

ROMIE TAGER Q.C.

CRAIG ORR

INGRID NEWMAN

Ref: RTDOCUME