The Lessons of the Lloyd's Litigation: The Duties of Lloyd's Agents

By Bernard Eder QC

Introduction

1. I should begin by confessing my interest. For the past two years, I have been heavily involved in various aspects of the Lloyd's litigation, acting principally for many of the Members' Agents in a number of actions (including "*Gooda Walker*" and "*Feltrim*") generally in the context of the LMX market. Having been in the thick of battle for so long, it is useful to stand back for a moment and survey the scene, remembering always that the litigation is still continuing.

Types of Lloyd's Agents

2. It is quite impossible to understand what Lloyd's agents duties are - or what the litigation has been (and is) about - without at least some knowledge of the legal framework in which Lloyd's agents operate. The best explanation can be found in the speech of Lord Goff in *[1994] 2 Lloyd's Rep @ p482*. But (at the risk of over simplification) here is a brief explanation - taken largely from the summary set out by Phillips J in his *Gooda Walker* Judgment.

3. Every person who wishes to become a Name at Lloyd's and who is not himself or herself an underwriting agent must appoint an underwriting agent to act on his or her behalf pursuant to an underwriting agreement. Underwriting agents may act in one of three capacities.

   a. They may be members' agents who (broadly speaking) advise Names on their choice of Syndicates, place Names on the Syndicates chosen by them and give general advice to them.

   b. They may be managing agents, who underwrite contracts of insurance at Lloyd's on behalf of the Names who are members of the Syndicates under their management and who reinsure contracts of insurance and pay claims.

   c. They may be combined agents who perform the role of members' agents and the role of managing agents in respect of the Syndicates under their management.

4. Until 1990, the practical position was as follows. Each Name entered into one or more underwriting agency agreements with an underwriting agent which was either a members' agent or a combined agent. Each underwriting agency agreement governed the relationship between the Name and the combined agent insofar as it acted as a members' agent. If however the Name became a member of a Syndicate which was managed by a combined agent, the agreement also governed the relationship between the Name and the combined agent acting in its capacity of managing agent. In such a case the Name was known as a direct Name. If however the Name became a member of a Syndicate which was managed by some other managing agent, the Name's underwriting agent (whether or not it was a combined agent) entered into a sub-agency agreement under which it appointed the managing agent its sub-agent to act as such in relation to the Name. In such a case the Name was known as an indirect Name.

5. In all cases, the main agency agreement - between each Name and members' agent or combined agent - and the sub-agency agreement - between a members' agent and managing agent - were in a

standard form as prescribed by **The Agency Agreements Byelaw No 1 of 1985** which came into force with effect from 1987. The important point to note is that there was, until 1990, no direct contract between an indirect Name and the managing agent. The latter was merely the sub-agent appointed by the members' agent or combined agent.

6. This structure was modified with effect from 1990 by **The Agency Agreements Byelaw No 8 of 1988**, the most important change being the introduction of a new direct contract between each Name and Managing Agent.

The initial stages of the Lloyd's litigation

7. The initial "crisis" was prompted by large losses suffered by Syndicates in the LMX market (ie Syndicates which wrote, in particular, XL on XL risks) as a result of a number of major catastrophes including the European windstorm known as 87J, Piper Alpha, Hurricane Hugo and 90A. This resulted in substantial "calls" for money being made by the Agents against Names to meet existing and anticipated claims.

8. Under the Agency Agreements, each Name was contractually responsible to pay calls; and there was an express contractual provision prohibiting any "set-off" ie even if a Name might be able to argue that the calls were in respect of losses which were the result of some breach of contract or negligence on the part of the members' agent or the managing agent, the Name remained liable in the first instance to pay the calls made.

9. In *Boobyer v Holman [1993] 1 Lloyd's Rep 96* an ingenious attempt was made to avoid or, at least, to circumvent this position by a Name seeking an injunction to restrain members' agents issuing notices for unpaid calls. However, such an argument was rejected without difficulty by Saville J.

10. This decision was significant in establishing the duties of members' agents in the making of calls. It also set the scene for the subsequent litigation as well as the pace of the litigation. The Names could not escape or avoid their obligation to pay calls. Their only remedy was to sue for damages in a separate action.

11. Broadly speaking, there were two main lines of attack:

(a) **Portfolio Selection**

First, there were what became known as the "portfolio selection cases". These were a number of cases brought by individual Names against their respective members' agents or combined agents in contract under the standard Agency Agreement for breach of duty in respect of some "personal" default by them. The main thrust of such cases was that the agents were in breach of duty in putting the Name on a Syndicate which was too "high risk" and/or in failing to give any or any sufficient warning of the extent of such risk. By their nature, these actions focused on the particular position of each individual Name, the relationship of such Name with his/her members' agent or combined agent, the overall structure of the Name's portfolio and the specific advice (if any) given to the Name prior to the joining of any particular Syndicate.

(b) **Negligent underwriting**

Second, there was a number of cases brought by large groups of Names in "group actions" in the High Court. The focus of such cases was quite different from that in the portfolio selection

cases viz the essential allegation was that the actual underwriting had been conducted negligently and did not depend upon a close examination of the individual position of each individual Name. From the point of view of case management, such cases thus offered huge advantages to large numbers of Names. In particular, the Names could join together with other Names and thereby share the costs of the litigation. In addition, it offered the opportunity to determine a large number of claims in one single action and within a much shorter time-scale.

It is convenient to consider these different lines of attack separately.

12. **Portfolio Selection Cases**

At a relatively early stage, a decision was taken to select one or more of the cases brought in the High Court as "lead cases". These became *Brown v KMR Services Ltd* and *Sword-Daniels v Pitel*. Mr Sword-Daniels was chosen on the basis that he was a so-called "unsophisticated Name". Mr Brown was selected as coming from the opposite end of the spectrum. These cases were tried together before Gatehouse J. and resulted in judgments against the Members' Agents: *[1994] 4 All ER 385*. The Brown case was appealed; and the Court of Appeal gave its Judgment on 12th July 1995. It is of considerable importance in setting out the duties of a members' agent.

13. There was no dispute as to the implicit duties owed by a members' agent. These were:

(a) to advise the Name which Syndicates to join and in what amounts;

(b) to keep him informed at all times of material factors which may affect his underwriting;

(c) to provide him with a balanced portfolio and appropriate spread of risk; a balanced spread of business on Syndicates throughout the main markets at Lloyd's;

(d) to monitor the Syndicates on which it places the Name and to make recommendations as to whether the Name should increase his share on a Syndicate, join a new Syndicate, reduce his share, or withdraw;

(e) to keep regularly in touch with the Syndicates to which the Name belongs;

(f) to advise and discuss with the Name the prospects and past results of Syndicates on which he could be placed.

14. There remained a critical question as to what a Members' Agent, in the position of the Defendant in that case, should have done to discharge his professional duty towards his Name. The following important points are taken from the main judgment given by Hobhouse LJ:

a. The duty to advise the Name which Syndicates to join and in what amounts has to be performed each year when the decisions have to be made for the following underwriting year. The advice therefore must cover both the selection of the Syndicates and the amount of premium to be allocated to each.

b. In selecting the Syndicates regard must be had to the classes of business in which the Name wishes to become involved, to the quality of the individual Syndicates, what business they write, and to what sectors of the market to be covered.

c. The agent must make recommendations which are of the appropriate quality both having regard to the individual Syndicates and the composition of the portfolio as a whole. Linked with this must be advice as to the amount of the allocation that the Name should make to each Syndicate. This must have regard to the same considerations - the character and quality of the Syndicate and the need to obtain an appropriate spread and maintain a proper balance.

d. Such considerations must apply to **every** Name whom the agent is advising but certain Names may need additional advice because of their special need to avoid risk. [Mr Sword-Daniels was held to come within that category; but not Mr Brown.]

e. Further, the agent must give the Name such information as is necessary for the Name to make a reasonably informed decision about the recommendations which the agent is making. The more that the Name is himself getting involved in the actual decisions (as opposed to leaving it to the agent) the more it is necessary that the advice given to the Name should include the appropriate information. In particular where a particular Syndicate involves some additional risk it is incumbent upon the agent to give an appropriate additional warning coupled with appropriate information. Where the Name is one who has a large commitment to Lloyd's and is attempting to take rational decisions about his investment, the agent should provide the Name with the information that is appropriate to the taking of such decisions.

f. Special consideration must be given with regard to the inclusion of "high risk" Syndicates in a Name's portfolio. It is incumbent upon the agent to give proper advice about the character and extra risk of the business underwritten by such Syndicates, individually and collectively. It must also include advice as to maintaining a proper balance between the allocation of premium to such Syndicates and the allocation of premium to Syndicates which are not high risk - and to keep a proper spread of risk.

15. Of the duties summarised above, those referred to in sub-paragraphs e and f are, perhaps the most controversial. Even in the light of this decision, it may well be extremely difficult for a Members' Agent to know exactly what to do and to be sure that what he is doing may not subsequently be characterised as in breach of duty. For example:

i. As appears above, it has now been held that **certain** Names may need additional advice because of their special need to avoid risk. But where is the line to be drawn? When does a Name like Mr Sword-Daniels (who fell into this category) become a Name like Mr Brown (who did not)?

ii. As also appears above, it has now been held that where a particular Syndicate involves some "additional risk", it is incumbent upon the agent to give an "appropriate" additional warning coupled with appropriate information. But how far does this go? Membership of many Syndicates (not only Syndicates writing XL risks) may involve accepting risks which could be said to be "additional". What is a "normal risk" ? What **precisely** is meant by "additional risk"? Equally, the question of what is or is not "appropriate" information may be the subject of endless debate.

iii. The problem of so-called "high risk" Syndicates is also a grey area. What is, and what is not, a high risk Syndicate ? If there is a very low prospect of a large loss, is that to be characterised as "high risk"?

a. Much will therefore depend upon the facts of each case. This was also confirmed by various comments made by the Court of Appeal following delivery of the Judgment - which comments are obviously important and will, I hope, be included in any subsequent report of the case.

Negligent Underwriting

16. This category of case gave rise to a number of legal and practical difficulties which became the subject of certain "preliminary issues".

17. First, there was the important question as to the **identity** of the proper defendant. Insofar as the Names' complaint was that the losses suffered were the result of "bad" underwriting, it might be thought that the main target was obviously the managing agent. A direct Name had no difficulty ie there was a direct claim in contract against the Name's combined agent. However, as already stated, prior to 1990 there was no direct contract between an Indirect Name and the Managing Agent. However, the House of Lords held that the Managing Agent could be sued by an Indirect Name in tort for breach of a duty of care: *[1994] 2 Lloyd's Rep 468.*

18. There was also an important practical difficulty faced by Names. The size of many of the losses was such that they far exceeded any remaining assets belonging to the Managing Agent, including any E&O cover which the Managing Agent might have. So a claim against the Managing Agents was of little practical value. In the event, the Names argued that although the Members' Agents did not do - and were not entitled under the Lloyd's Byelaws to do - the actual underwriting themselves, nevertheless they were contractually responsible for the actual underwriting under the terms of the standard Agency Agreement existing prior to 1990. That argument was also upheld by the House of Lords:*[1994] 2 Lloyd's Rep. 468.* This decision was of immense importance in the context of the overall shape of the litigation. It meant that Indirect Names could sue not only the Managing Agents in tort but also the Members' Agents in contract for negligent underwriting.

19. In particular, this decision set the scene for the main trial in *Gooda Walker*. The claims in *Gooda Walker* were based solely upon an allegation of negligent underwriting. They were formulated against the Managing Agents in tort as a breach of a duty of care and against the Members' Agents on the basis of their contractual responsibility for the actual underwriting under the Agency Agreement.

20. At an early stage of the *Gooda Walker* trial, Phillips J made an important ruling to the effect that the allegations of negligent underwriting were unaffected by the position of individual Names or the advice which might have been given by any particular Members' Agent to any particular Name.

21. The concept of "negligent underwriting" requires some explanation. The first thing that anyone will tell you about Lloyd's is that membership brings unlimited liability. It is well known that this will be drummed into any Name joining Lloyd's. I am often told: if that is so, there can surely be no basis for criticising an underwriter for exposing his Names to huge, even unlimited, liabilities. How can it be negligent to expose a Name to unlimited liability if unlimited liability is the touchstone of membership of Lloyd's? The answer is quite simple. The fact that a Name accepts unlimited liability does not entitle the underwriter to act negligently. The concept of unlimited liability and the duty to exercise reasonable care are not mutually exclusive.

22. Thus the focus of attention in *Gooda Walker* was not merely that the Names had been exposed to the risk of very large losses; but rather that the underwriting had been conducted negligently and that the exposure to the risk of large losses was the **result** of such negligence. This distinction is fundamental to a proper understanding of the Judgment in *Gooda Walker*.

23. That there was a general obligation to carry out the actual underwriting with reasonable skill and care was common ground in *Gooda Walker*. But the critical question (as in the *Brown* case) was whether that duty had been discharged in the context of the particular business carried on by the particular Syndicates. In that context, the Judge's conclusions may be summarised as follows:

a. The fact that a Name who joins Lloyd's deliberately agrees to expose himself to unlimited liability does not mean that he anticipates or accepts that when he joins a Syndicate the active underwriter will deliberately expose him to the risk of such liability.

b. On the contrary, the Name will reasonably expect the underwriter to exercise due skill and care to prevent him from suffering losses.

c. The underwriting must be conducted as an ongoing business and there is no reason in principle why an underwriter should not write business on the basis that net losses will be made in some years that are balanced by generous profit levels in other years.

d. However, if an underwriter is deliberately to expose his Names to suffering losses from time to time, he must make sure that the Names are aware of this and of the scale of loss to which they will from time to time be exposed.

e. It was incumbent upon any underwriter to have a plan and follow it. In particular, any competent underwriter had to formulate and follow a policy as to the extent to which Names were to be exposed to the risk of loss.

f. It was a fundamental principle of excess of loss underwriting that the underwriter should formulate and follow a plan as to the amount of exposure that his Syndicate would run.

g. Although projections were not "inflexible", the underwriter must monitor his business properly so that he knows what he is doing; and he should not make so radical a departure from his policy on exposure as to betray the reasonable expectation of his Names.

h. So far as an XL underwriter is concerned, such "monitoring" will include:

   i. Monitoring of aggregates;

   ii. An estimation of the PML (ie the probable maximum loss) as the result of a single event made by the application of judgment to the data available.

i. In addition, the underwriter should adopt a reinsurance policy which involves, at the very least, working out, having regard to the PML, what net exposure he is prepared to run in that event and, so far as possible, reinsuring the balance.

24. Other important areas of potential criticism which often arise concern the underwriter's decision to effect a RITC (reinsurance to close) and, in particular, the calculation of the necessary RITC premium; and, in a related context, the placement of run-off reinsurance with "outside" Syndicates. The latter was the subject of consideration by Potter J. in *Aiken v Stewart Wrightson Members Agency Ltd & Others [1995] 1 WLR 1281*. The case is of particular importance in establishing that a managing agent owes duties not merely to his Names in year X when deciding whether and by what steps to close that year but that they also owed a duty to safeguard the interests of the subsequent years.

25. In each case, it will be necessary to consider whether or not the underwriter has exercised reasonable skill and care - and this will obviously depend upon the particular type of business and facts in each case.

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