

Lexington -v- Wasa
Lexington -v- AGF
House of Lords, 30 July 2009
Reinsurance

Further information

If you would like further information on any aspect of the Lexington -v- Wasa decision and its surrounding issues please contact the person mentioned below or the person with whom you usually deal.

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<http://www.publications.parliament.uk/pa/ld200809/ldjudgmt/jd090730/lexing-1.htm>

[LEXINGTON -V- WASA

LEXINGTON -V- AGF

[2009, UKHL 40]

Judgment 30 July 2009

- The House of Lords finds for reinsurers, in a ruling of strict orthodoxy and traditional insistence on the primacy of the contract terms.
- An English law facultative reinsurance contract is not to be read so as to cover damage arising outside the period of cover, even if the primary policy, governed by Pennsylvania law, is adjudged by a US court to grant such coverage.
- Reinsurers have no obligation to follow a settlement - or a judgment - that would not be covered by the reinsurance policy as a matter of law.

Reinsurance and the House of Lords

It's rare for a reinsurance case to reach the House of Lords.

Indeed it's rare for *insurance* cases generally to come before the highest court in the land.

Leave aside market issues such as *Lloyd's R&R*, *Kuwait Airways*, *HIH*, *Pensions Mis-selling* and *Asbestos*, and one can see that their Lordships have not really "*had a go*" at the trickier bits of insurance or reinsurance for quite a while now.

The *Star Sea* probably deserved its brief run-out - after all, the doctrine of *utmost good faith* is pretty fundamental to reinsurance.

But even these cases didn't really tell us very much about the nature of reinsurance.

And you can literally count on the fingers of two hands - with a few spare digits to count them with - the occasions on which reinsurance proper has been the subject of their Lordship's scrutiny.

In the 20th Century, it was usually Lloyd's or Lloyd's Syndicates which

were the generators of most of the reinsurance cases that got before the House of Lords, and then the action really only began after Lloyd's had begun to enter the hurricane of post-1987 troubles that led to R&R:

Vesta v Butcher, *Henderson v Merrett*, *Charter Re v Fagan*, *Axa Re v Field*, *Hill v M&G Re*, *Baker v Black Sea* - and that's about the sum of it, so far as their Lordships have ever looked at reinsurance.

In the current century, only a small flurry of Bermuda business, in *Aneco v J&H*, provided enough wind-power to propel a reinsurance case right up to the Lords.

So it is not altogether surprising that there were - and are - a few reinsurance ghosts and myths lying around from the 19th Century which need to be laid to rest or put into a modern context.

Where better to carry out that task than in the context of yet another extraordinary (to English eyes) ruling from a US Court on the scope of insurance coverage for a pollution claim?

Lexington v Wasa provided ideal storm conditions.

At last, the very "nature of reinsurance" and the export of US liability theories to London Market and European reinsurers through facultative contracts would both come before their Lordships, in a form fit for thorough analysis and exorcism of some of the odder aspects of the English law of reinsurance.

Well that was the theory and expectation.

Here's how the story unfolds:

The contracts

Lexington Insurance Co ("Lexington") insured the Aluminium Company of America ("Alcoa") against property damage at Alcoa's sites around the world. Lexington reinsured the risk with a number of reinsurers, including Wasa International Insurance Company

Limited ("Wasa") and AGF Insurance Ltd ("AGF"), by way of facultative reinsurance. The periods of both the insurance policy and the reinsurance were 1 July 1977 to 1 July 1980. The contracts were effectively back-to-back as regards their terminology, perils insured and (significantly) period of cover, but the insurance policy, a "Difference in Conditions" property insurance cover, was found to be governed by Pennsylvania law, and the reinsurance, a "contributing facultative" J1 form reinsurance slip - with a substantial retention - was impliedly governed by English law.

The facts

In the early 1990s Alcoa was required by the US Environmental Protection Agency and various state environmental agencies to clean up pollution at numerous manufacturing sites used by Alcoa in the United States. Alcoa consequently issued proceedings in the State of Washington in the United States, for a declaration of entitlement to insurance coverage in respect of the clean-up costs at a number of these manufacturing sites against its insurers who had provided liability or all-risks property insurance to Alcoa for the period 1956 to 1986, including Lexington.

US proceedings

On appeal from the Superior Court of King County in Washington state, and applying Pennsylvania law (the state where Alcoa's headquarters were located), the Supreme Court of Washington held that insurers, including Lexington, were jointly and severally liable to Alcoa for all the damage, *including that which had occurred before and after the period of insurance with Lexington*. This was a case in which the Washington Court held in substance that the original insurance contained no relevant time limitation as regards the time of the physical loss or damage to property (see per Lord Collins para 109-111).

The decision of the court below was not to the effect that losses occurring during

the policy period encompassed liability or losses flowing from damage which occurred during that period. It was a decision that, provided there was *some* damage in the policy period, the insured had a right to indemnity for liability flowing from damage *whenever* it might have occurred - before, during, or after the period of coverage.

Faced with a claim of approximately US\$180 million from Alcoa, Lexington settled with Alcoa in 2003 for US\$103 million. Lexington then looked to its reinsurers at which point Wasa and AGF commenced proceedings in London seeking a declaration that they were not obliged to indemnify Lexington in respect of its settlement with Alcoa.

English proceedings

The Commercial Court found in favour of reinsurers on the basis that the reinsurance policy was governed by English law, so reinsurers could only be liable for the costs incurred in remedying damage which occurred during the policy period and not before or after that period.

The Court of Appeal, however, upheld Lexington's appeal and found that the parties intended the insurance and reinsurance to be back-to-back, so the period clauses in the policies were intended to have the same meaning. Thus, on the basis that the US court found that the insurance policy covered pollution for the period 1956 to 1986, so too should the reinsurance policy.

And yesterday, in one of the last ever rulings of the House of Lords, which will be replaced by the brand-new Supreme Court in the autumn, the judges agreed with the first judge to consider the matter, reversed the Court of Appeal, and denied the American reinsured any recovery from its reinsurers.

Key Points

The deciding points were:

- the fact that the two contracts were subject to different laws, and
- the English law contract could not be read to extend to coverage of

damage occurring outside the period of coverage of the reinsurance contract, which was clearly stated as three years.

The fact that the general principle of facultative reinsurance was a presumption of "back-to-back coverage; the inclusion of a Full Reinsurance Clause; "as original" wording; and a follow settlements clause all could not save the reinsured.

It was, said their Lordships, a simple matter of construction of the reinsurance contract.

And this contract did not cover damage occurring outside the period of coverage.

The speeches

Their Lordships were, unusually these days, *ad idem* both as to the result and to the reasoning.

Lord Mance and Lord Collins provided the real firepower, and Lords Phillips, Walker and Brown largely agreed with one or other of those - or both, since Lord Collins and Lord Mance also agreed with each other.

When an appellate panel says that things are "*obvious*", "*clear*", and "*elementary*", it is a sure sign that they are going to upset somebody quite a lot. When they say that propositions "*cannot reasonably*" be maintained, and proceed to disagree with the Court of Appeal below which reached just those conclusions, litigants begin to despair, and wonder why they didn't elect for arbitration and a single arbitrator.

In *Lexington v Wasa*, the rulings turned on:

- the fundamental nature of the period of cover for which the reinsurers had contracted and
- the fact that the insurance and the reinsurance were subject to different governing laws.

At bottom, the question was not one of metaphysics, or of principle, but of construction of the reinsurance contract,

in accordance with its governing law - which was English.

Admittedly, there was a strong presumption that a "*contributing facultative*" reinsurance ought to provide cover co-extensive with the insurance, particularly where identical terminology is used.

But the law is the law, and according to their Lordships, English law regards the period of cover as rather more fundamental than does (in this case) Pennsylvania law.

A "clear temporal limitation" could not be overridden, let alone "trumped" by presumptions, "as original", "Full Reinsurance Clauses" or follow settlements clauses.

The US court's ability under its own legal system to dump into the period of cover a whole raft of liability that occurred before and after the same period could not flow through to the reinsurers. Reinsurers had made their own bargain. The fact that they got a proportional share of the premium did not mean that they automatically took the same risk as the insurer.

This is the point at which Lexington had resort to rhetoric:

"How, (they asked,) could we possibly do anything more to make these contracts back-to-back than we have done? With a full reinsurance clause; as original wording; follow settlements clause; and pro rata premium, what more do we need?"

Their Lordships did not say, exactly...

But they certainly suggested that the market should make every effort to change their wordings to make things clear.

Lord Mance even suggested that reinsurance practitioners, who, he said, were "*experts, possessing very considerable legal knowledge and expertise - (even if past experience indicates not invariably)*" should insist that the whole of any insurance and reinsurance programme should be

expressly subjected to a common governing law.

One could almost hear the hollow laughter from insurance and reinsurance brokers and purchasers from both sides of the Atlantic. "*Who does he think we are? Bankers?*" It is unlikely that the reinsurance market will respond positively to that suggestion in any foreseeable universe.

The traditional antipathy of English judges to the deployment of follow settlements clauses to slide into a reinsurance contract something that was not as a matter of law included in the reinsurance contract was also evident and strident in the speeches. If the claim was not covered as a matter of law by the reinsurance contract, a duty to "*follow settlements*" would not assist.

The traditional status of reinsurance as a reinsurance, not of the liability of the reinsured under the insurance, but a reinsurance of the subject matter insured was also re-iterated, approved by all the judges, and apparently accepted by the parties in the case as being binding and orthodox law.

The regulatory implications of adopting as legal theory that which was admittedly a commercial reality - reinsurance as covering the *liability* of the reinsured under his contract - were too horrendous to contemplate in this case.

Lord Collins held open the possibility of re-visiting this point, but said that he would want submissions from no less a body of luminaries than Lloyd's, the ABI, and BILA as well. The FSA was, rather surprisingly, not invited to be a participant in that future debate...

Conclusions:

In virtually its "last word" to an expectant market, the House of Lords has revived the belief of non-US reinsurers that the reinsurance contract is still a stand-alone, enforceable contract, and not merely a blank cheque on some form of global syndication of a primary insurance policy.

Reinsurers are not bound to take every bit of rough that the inventiveness of the US tort system can produce along with the smooth.

Suitable wording and clear language in the reinsurance contract can ensure that the terms of that contract are indeed writ in stone, and proof against foreign deviations from the natural and ordinary meaning of English words as read and understood by English people.

And in the end, it is all a ***matter of construction***...

Some implications for the market

The implications of this ruling for US cedants, the London and overseas reinsurance markets, and the flow of US liability across the Atlantic are potentially very considerable.

Whilst each reinsurance contract will fall to be considered - as a matter of construction - on its own terms, the presumption of congruency of insurance and facultative reinsurance has been shown to be rebuttable by plain words.

What words will be found by the market of the future to bind reinsurers more closely to the fortunes (sic) of their reinsureds? How clear can the contracts be? Can one really expect every risk programme, like a bank syndication, to be subjected to a common governing law?

To what extent should local insurers, "*fronting*" for London and Continental European reinsurance markets, now seek to tighten up their wordings? The answer must be "Soon" and "Plenty". Blind reliance on a "*full reinsurance*" and "*follow settlements*" clause will leave the primary insurer with a massive exposure to the unpredictable but customary pro-insured jurisprudence of the local courts, unless the reinsurance is more tightly worded - or subjected to the same law as the primary policy.

And how many reinsurers will readily agree to that in a hardening market?

How far will this ruling extend into the coverage of APH more generally, for

example in relation to CGL and XOL coverages? That is a very big question.

But if the "*period of cover*" is so fundamental a term that it trumps a "*follow*" clause, "*full reinsurance*" and "*as original*" wordings, on a pro-rata reinsurance deal, one has to wonder how far behind will be the next test case on the meaning of, say, "*event*" or "*occurrence*" in an English law reinsurance contract covering a US CGL policy.

Will that situation be a *Lexington* result - in favour of the reinsurer? or a *Vesta v Butcher/Catatumbo* result - in favour of the reinsured?

Is "*event*" (or "*occurrence*") a term which is to be treated like the term "*warranty*", in the *Vesta* and *Catatumbo* cases, and diluted into a meaning more attuned to the primary policy's coverage and laws? (see the discussion in *Lexington* at paras 66-72)

Would a reinsurer's insistence on a purely English meaning of "*event*", be, as their Lordships derided the invocation of the term "*warranty*", in *Vesta* and *Catatumbo*, a "*wholly unmeritorious point*", based on a meaning that was "*of stubbornly domestic English significance*", such that London Market reinsurers should read it, in their contract, as having the same meaning as the underlying US laws and Courts would give to it in respect of the primary insurance?

Or would the term be seen, like the period of coverage in *Lexington*, as a *fundamental* term to which an English court must give an English interpretation, regardless of the contortions of the primary jurisprudence?

Whichever way that debate goes, it will not be the House of Lords which delivers the answer.

It might, on the other hand, be the new Supreme Court...

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