

Wasa v Lexington - the repercussions for reinsurers

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The House of Lords handed down its much anticipated judgment on 30 July. Its decision to allow the reinsurers' appeal and to refuse to accept Lexington's contention that the insurance and reinsurance contracts should be construed as "back to back" will be a popular one amongst many London market reinsurers conducting business in the US and equally pro-insured jurisdictions.

The presumption that a proportional facultative contract should be construed as co-extensive with the underlying direct policy remains valid. However, this does not mean that a reinsurance contract which is subject to English law will be construed in a different manner from its ordinary meaning in the London insurance market in circumstances where, at the time of underwriting, there was no identifiable system of law applicable to the direct policy which could have provided a basis for a different construction.

The House of Lords found that the reinsurers, who had written a three year policy, were not liable for 30 years of

damage despite the contrary conclusion having been reached by the Washington Supreme Court, applying Pennsylvania law, in respect of the underlying insurance policy written by Lexington which provided cover for the same three year period.

The earlier Court of Appeal decision was controversial. It left many uncertain of their potential exposures, whether they had sufficient reserves in place and whether their own outwards protections would respond as previously anticipated. In essence, the Court of Appeal decision had meant that reinsurers were exposed to the same risk whether they had written the contract for three years or less, thereby emasculating the period

provision in the reinsurance. The very real commercial difficulties with which London reinsurers were faced were recognised by the House of Lords.

Key facts

Lexington had insured Aluminium Company of America (Alcoa) under a property damage and business interruption policy for losses occurring during the three year period commencing 1 July 1977. The policy did not contain an express choice of law clause but did contain a standard US Service of Suit clause. Lexington obtained facultative reinsurance cover from, amongst others, Wasa and AGF, on the same terms and conditions "as original", including the same

three year period of cover and a full reinsurance clause as follows:

"Being a Reinsurance of and warranted same gross rate, terms and conditions as and to follow the settlements of the ...Company..."

Although the reinsurance slip policy did not contain an express choice of law clause, it was accepted by the parties that English law applied.

In the 1990s, Alcoa incurred substantial clean up costs in respect of pollution, which had taken place between 1956 and 1985, at various of its manufacturing sites in the US. Alcoa turned to the Washington courts for a declaration of entitlement to insurance coverage for these costs. Some of Alcoa's insurers for the 30 year period in question escaped liability because of relevant exceptions or liability provisions in their policies and some because they simply could not be traced. Lexington was not so fortunate.

The Supreme Court of Washington, applying Pennsylvania law (as it was entitled to pursuant to the Service of Suit clause in the direct policy), held Lexington jointly and severally liable for all damage, including that which pre- and post-dated the three year period of cover specified in its insurance policy with Alcoa. It did so by applying a principle of construction previously adopted by a number of other US states for the interpretation of property insurance contracts and having its origins in the realm of asbestos claims, namely joint and several liability for the full amount of damage regardless of the amount caused during the express policy period.

Lexington was faced with an exposure of approximately \$180 million but the parties ultimately settled for \$103 million. This settlement was later accepted by the reinsurers to have been made in an honest and businesslike manner (it having been established by the Supreme Court of Washington that the entire claim fell within the insurance). The significance of this point was that the House of Lords was thereby not called upon to assess whether this aspect of the *ICA v Scor*¹ test had been met. Instead, its focus was on the other proviso namely,

whether, as a matter of law, the original claim was within the risks covered by the policy of reinsurance.

Facing this substantial claim from Lexington, Wasa and AGF declined to pay. Whilst they did not go as far as to contest that the US court decision was perverse, they did argue that the reinsurance policy was governed by English law and that, under English law, the period clause in a policy is a fundamental term which, in this case, would be interpreted as providing cover for three years, not 30. The English court of first instance accepted the reinsurers' case.

Court of Appeal judgment

However, this decision was overturned by the Court of Appeal. It accepted Lexington's contention that the "back to back" presumption should be applied in cases involving proportional facultative reinsurance where the same or equivalent language is used in both policies. Following earlier cases (*Vesta v Butcher*² and *Groupama v Catatumbo*³) the Court found that, despite the contracts being governed by different laws, the period clauses in both should be interpreted uniformly and in accordance with the Supreme Court's determination. Although the US decision may never have been anticipated by the reinsurers, the Court of Appeal considered that part of their bargain with Lexington had been to share the risk of an unfavourable development in the law.

The House of Lords judgment

The House of Lords decision should restore certainty and provide some comfort to London reinsurers. As mentioned above, the Lords accepted that the normal commercial purpose of proportional facultative reinsurance policies is to provide "back to back" cover with the direct policy and therefore the terms of the direct and reinsurance should generally be interpreted consistently. However, the Lords stated that, where the contracts are governed by different laws, then it remains a question of construction of both contracts as to what risk is assumed. There are no special conflict of laws rules which govern the consequences of any inconsistency.

The Lords noted that both policies were on a "losses occurring during" basis and that,

1 [1995] 1 Lloyd's Rep 312 (CA)

2 [1989] AC 852

3 [2000] 2 Lloyd's Rep 350

under English law, this meant that the (re)insurer is liable to indemnify the (re)insured in respect of loss or damage which occurs during the policy period. It was common ground between the parties that, under English law, the three year period contained in the reinsurance contract would be interpreted as only covering property damage which occurred during the three year reinsurance period.

In his judgment⁴, Lord Collins observed that in 1977, when both of the contracts were concluded, there was no identifiable system of law applicable to the insurance contract which could have provided the reinsurer with the basis for construing the reinsurance contract in a manner different from its ordinary meaning in the London insurance market. This distinguished this case from the factual background to the **Vesta** and **Catatumbo** judgments cited by Lexington where it was possible to identify the foreign law which governed the insurance and in respect of which the reinsurers thereby had the opportunity to research how their reinsurance policies were likely to be interpreted.

Whether the Lords were solely influenced by this distinction seems unlikely. In both of those cases, reinsurers had argued that they should be relieved from liability because the original insured (rather than the reinsured) had been guilty of a breach of warranty. Such breaches had not been causative of the loss in question. The courts saw these as "technical" defences and had little sympathy with the reinsurers. In this regard, reference should be made to the Law Commissions' proposed reforms of insurance law. In this case, however, Wasa was a more obvious victim of the vagaries of an pro-insured judicial system.

The Lords recognised that reinsurance policies are increasingly the product of considerable market and legal expertise, the obvious implication being that the clauses contained in the reinsurance contract, including its governing law, are inserted for good reason. They noted that reinsurance contracts are separate legal contracts from the underlying policies and may contain independent terms requiring satisfaction before reinsureds can claim under them.

The Lords held that the reinsurance contract could not reasonably be construed to mean that it would respond to any liability which "any court of competent jurisdiction within the United States" would impose on Lexington, irrespective of the period of cover in the reinsurance contract. The effect of the Supreme Court's decision was to impose liability on Lexington under the insurance policy for loss and damage which occurred before, during and after the policy period in the reinsurance contract.

Examining the reinsurance from an English legal perspective, the Lords found that the application of the Supreme Court of Washington's judgment to the reinsurers would lead to "fundamental and surprising" changes in the ordinary understanding of reinsurance and of a reinsurance period clause, and create unpredictable exposures for the reinsurers. The Lords observed that, under the US court's approach, reinsurers must have incurred liability, up to the reinsurance limits, before the reinsurance policy period had even commenced.

The Lords stated that they did not agree that "full reinsurance" and "follow the settlements" clauses have the effect of bringing within cover a reinsurance risk that, on the true interpretation of the policy, would not otherwise be covered.

In summary, the Lords found no rule of construction, and no rule of law, that a reinsurer must respond to every valid claim under an insurance policy, irrespective of the actual terms and conditions of the reinsurance contract.

Conclusion

It is clear from the Lords' decision that they are not intending to usurp the presumption that proportional facultative reinsurance policies and reinsurance contracts should be construed as being "back to back". That remains the accepted starting point. However, the Lords were not prepared effectively to ignore the fact that the parties to the reinsurance had entered into a bargain on the basis of English law and had legitimately expected that the period provision in their contract would be given its ordinary meaning, not the (to English eyes) surprising interpretation arrived at by the

⁴ Paragraph 55 (6)

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Supreme Court of Washington. Thereby, the "uncommercial consequences" for reinsurers, referred to by Lord Collins were averted.

Nevertheless, going forward, London reinsurers are best advised to avoid too heavy a reliance upon the distinction afforded them by a different governing law

in their reinsurance contract in circumstances where other terms and conditions reflect the underlying policy - particularly so where there is a risk of the courts considering their defences to be unmeritorious. ■

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