

News flash

Following the Settlements: How not to clean up!

Simon Gildener reviews the recent reinsurance coverage case of *Wasa v Lexington*¹ and considers what lessons may be learned by reassureds seeking to enhance their prospects of a successful reinsurance recovery.

Background

1. Alcoa is a very large producer of aluminium. Between 1942 and 1986, Alcoa's waste management and pollution containment procedures had been defective. These deficiencies caused environmental damage at a number of its industrial sites across the United States. In the early 1990s, the US Environmental Protection Agency forced Alcoa to take remedial action.
2. Alcoa was insured by Lexington (and a number of other insurers) for a three year period between 1977 and 1980. It was during this period that much of the environmental damage had manifested itself. Alcoa tried to recover all of the clean-up costs from Lexington. Lexington argued that it should not be responsible for everything. The cause of the damage was a continuing state of affairs, and Lexington was on risk only for three of the forty (plus) years involved. Alcoa asked a Washington State court (applying the law of Pennsylvania) to rule on when the relevant damage occurred and whether the clean-up costs should be allocated pro-rata across the years.
3. In 1997, the trial judge decided that the environmental damage had occurred on a gradual, linear basis. Therefore the remedial costs could be pro-rated across all of the years during which the damage occurred. However, in May 2000, the Washington Supreme Court reversed the decision. It held that the insurance policy language was broad enough to provide cover for any damage manifesting itself during the policy period, including pollution damage that had started before the policy inception. Lexington found itself liable to Alcoa for all of the clean-up costs, not just that proportion attributable to the three year policy period. Lexington tried to reduce its financial exposure to Alcoa but eventually settled for just over \$100 million.

The Reinsurance

4. Lexington had reinsured the Alcoa risk on a facultative basis. Wasa International Insurance Company ('Wasa') and AGF Insurance ('AGF') had small lines on this reinsurance. Lexington asked Wasa and AGF for their contribution to the settlement. Wasa and AGF issued proceedings in the London High Court for a declaration that they were not liable to pay.
5. The relevant slip provided that the contract was "...a reinsurance of and warranted same gross rate, terms and conditions as and to follow the settlements of the [reassured]." The key question was whether Wasa and AGF were obliged to follow the settlement.
6. Wasa and AGF argued that, as a matter of law, the reinsurance contract did not cover Lexington for losses arising out of long-term damage, only physical damage actually occurring during the three year period. If that was right, then the settlement would not fall within the scope of the reinsurance contract. Lexington argued that the reinsurance was 'back-to-back' with the original insurance, even though the original insurance was subject to US law, and the reinsurance was subject to English law. As a result, it said the intent of the parties must have been to incorporate the same meaning and effect of the insurance policy into the reinsurance.

The decision

7. The judge (Mr Justice Simon) considered the leading cases on settlement clauses, including *Insurance Co of Africa v Scor (UK) Reinsurance*². For the kind of wording in issue in this case, a reassured did not have to prove that the loss fell within the scope of the insurance contract as a matter of law. It needed only to act honestly when making the settlement, and to take all proper and business-like steps

1. [2007] EW-HC 896 (Comm.)

2. [1985] 1 Lloyd's Rep 312



- ▶ in settling the claim. However, once the reassured got over that hurdle, it still had to prove that the loss fell within the scope of the reinsurance contract as a matter of law.
8. It was common ground that Lexington had acted honestly and taken all proper and business-like steps in settling with Alcoa. So did the claim fall within the scope of the reinsurance? The judge recognised that the contracts were ‘back-to-back’ in terms of terminology, but he could not overlook the impact of the two different jurisdictions as a matter of contract interpretation. It was therefore open to him to take a different view on cover.
 9. In his view, the reinsurance contract period was a key factor here. It provided a temporal limit to the cover and it would not be right to distort or disregard the natural meaning of a period clause, even in a ‘back-to-back’ situation.
 10. He reviewed a number of cases in which English courts had chosen to interpret reinsurance contract wordings in a manner which was consistent with foreign courts with jurisdiction over the original contract. In these particular cases, he considered that it was a relatively straightforward exercise to imply a consistent contractual intent. In the Alcoa case, it was not.
 11. The judge was influenced by the fact that there was no uniform rule of law applicable across the US, and that the original decision between Alcoa and Lexington might well have gone differently in another state jurisdiction (e.g. New Jersey). There had been no express choice of law/jurisdiction clause in the original insurance, so there could not have been any certainty about where any dispute would be litigated at the time of contracting. In the judge’s view, the parties to the reinsurance contract could not have had in mind that a coverage dispute regarding the original insurance would be litigated 20 years later in a Washington court applying Pennsylvanian state law. If the judge had to interpret the period clause in the reinsurance contract using nothing but hindsight to guide him, then this contract would not be ‘back-to-back’ but ‘back-to-front’.
 12. The judge found that the reinsurers had agreed to cover Lexington only for damage occurring during the policy

period (or as the slip put it, “*during the continuance of this Policy*”). They had not agreed to cover Lexington for damage occurring before or after the policy period, nor had they agreed to cover Lexington for such period that a US court might subsequently determine. As result, they were not bound to follow the settlement.

Comment

13. This case is an important reminder to reassureds that even ‘back-to-back’ reinsurance cannot be guaranteed to mirror the original risk. The likelihood of inconsistent contractual interpretations is substantially increased by the adoption of different jurisdictions. Even though the terminology of the original risk may be incorporated word-for-word into the reinsurance contract, it does not necessarily follow that it will mean the same thing to a foreign court. It remains essential to use clear contractual language and to consider the impact of jurisdiction at the outset. Where there are many possible jurisdictions (as in this case), this will not be easy. But prevention is much more effective than cure.
14. As is a fairly common market practice, Lexington notified the Alcoa settlement to reinsurers after it had concluded. Notification duties are a question of contract, and there is no indication that Wasa and AGF would have acted differently if they had been involved in the settlement process. But in some cases, it may be commercially prudent to bring reinsurers into the settlement process early. Particularly where large losses are concerned. Again, it is prevention rather than cure.
15. One final footnote remains. Lexington has asked the Court of Appeal for permission to appeal and a decision on this is expected in the early summer.

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We can put together a seminar/talk or panel discussion on the issue above, or any of the issues featured in our publications to be held at any of our offices, or yours. If you are interested, please contact any one of our lawyers or **David Simon at david.simon@robinsimonllp.com.**

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