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Legal Newsflash

Topical Update from Robin Simon LLP

Following the Settlements : a clean sweep at the House of Lords

In May 2007 and April 2008 we considered the impact of the High Court and Court of Appeal decisions respectively in *Wasa v Lexington*. The Court of Appeal's decision was received with disappointment by reinsurers, as it had the potential to leave them open to much larger exposures than they might have anticipated. The House of Lords has now reversed the decision of the Court of Appeal, in a much-anticipated judgment handed down on 30 July 2009. *Joanne Staphnill* considers the impact of the House of Lords decision.

The decision highlights important issues for those seeking or providing reinsurance across different legal systems and jurisdictions, and we examine these below. Similarly, the lessons of the case are relevant to FI, D&O and PII policies wherever there might be an interaction between a worldwide policy and local policies.

In brief summary, Lexington entered into a 3-year insurance without a specified choice of law. Wasa's reinsurance of that risk was subject to English law. The core question within this 'follow the settlements' dispute was whether the parties intended that Wasa should indemnify Lexington against all the losses it had suffered, after Lexington was held liable to indemnify for the cost of cleaning up environmental damage caused over a period of more than 40 years. The Lords held that the reinsurance should be interpreted in accordance with English law, because, significantly, the parties could not have identified what law would govern the underlying insurance at the time of entry into the reinsurance. As a result, Wasa was not liable to indemnify Lexington against its total loss.

Background

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.

Alcoa was insured by Lexington (and a number of other insurers) for the 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 (which decided to apply 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.

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

In 1977, Lexington had reinsured the Alcoa risk on a facultative basis. Wasa International Insurance Company ('Wasa') and AGF Insurance ('AGF') had small lines (2.5% and 1.5% respectively) 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.

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.

Wasa and AGF argued that 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 were right, then the settlement would not fall within the legal scope of the reinsurance contract.

Lexington argued against this, 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 in 1977 must have been to incorporate the same meaning and effect of the insurance policy into the reinsurance.

The High Court Decision

At first instance, Mr Justice Simon held that Wasa had agreed to cover Lexington only for damage occurring during the policy period applicable to the reinsurance. This meant that the Alcoa settlement largely fell outside the scope of the reinsurance contract. Wasa therefore did not have to follow Lexington's settlement.

A key factor in the judge's decision was the lack of a uniform rule of law applicable across the whole of the US and the lack of an express law/jurisdiction clause in the original insurance. In his view, neither Wasa nor Lexington could have foreseen in 1977 that there would be a coverage dispute 20 years later which would be litigated in a Washington court applying Pennsylvanian state law. On that basis, neither party could have intended the English reinsurance contract to be interpreted in the same way. There was no "*consistent contractual intent*" between the insurance and the reinsurance contracts. To say otherwise would, in the judge's view, have made the reinsurance contract "*back-to-front*", rather than "*back-to-back*".

The Court of Appeal

Lexington's appeal went before the Court of Appeal in early 2008. Longmore LJ gave the leading judgment.

As his starting point, Longmore LJ stated that where contractual terminology was the same or similar in both contracts in issue, it was important not to ask whether the parties intended the provisions to be "*back-to-back*" as such, but to ask whether they intended the provisions to have the same meaning in both contracts. Explaining this apparent exercise in semantics, he argued that his own formulation left it open for the court to go on to determine what that meaning was.

On reviewing the period clauses in both contracts, he noted that they were effectively identical, even though expressed in slightly different words. And, after applying his test, he considered the natural answer was that the parties must have intended the words to have the same meaning in both contracts. Lending support to this view, he noted that Lexington had ceded the entirety of the Alcoa premium. This, he felt, was indicative that the parties to the reinsurance intended the entirety of the risk to be ceded.

So what was that common meaning? Did Wasa's English interpretation (in effect, pro-rated damage across the three years only) or Lexington's Pennsylvania interpretation (all damage) apply? After distinguishing a number of legal authorities, all three appellate judges agreed that it made little sense for Wasa's English approach to apply in this case.

Unlike the judge at first instance, Longmore LJ felt that it was possible to imply a consistent contractual intent in circumstances where multiple American state jurisdictions with differing legal approaches might well have come into play. Longmore LJ decided that in 1977, both Wasa AGF and Lexington would have "*probably*" concluded that Pennsylvania law would apply to the insurance contract. This would then make it possible to ascertain the meaning of the contract at that stage, even if it were a matter of disagreement between lawyers, eventually requiring a court determination some 20 years later. And even if the law had changed in the intervening period (a point argued by Wasa), reinsurers took the same risk of a change in law in the insurers' country of operation as the insurers did.

He accepted that the Washington State court did not focus on the period of cover in the same way that an English court might have done, but the contract period was still an important part of the policy under judicial construction in the US. On that basis, it had to bear the same construction in both insurance and reinsurance contracts.

The House of Lords

The five Lords unanimously allowed Wasa's appeal, even though Lord Mance acknowledged the "general attraction" of the Court of Appeal's answer to the issues raised in this case.

A well-known principle was reiterated; a reinsurer could not be held liable unless the loss fell within the risk assumed under the underlying insurance, and the relevant risk had been assumed under the reinsurance¹. The Lords also accepted that there will be a strong presumption that liability under a proportional facultative reinsurance was co-extensive with the underlying insurance, because the essence of the bargain was that the reinsurer took a proportion of the premium in return for a share of the risk. However, where the insurance and reinsurance contracts were governed by different laws, it remained a question of construction under each contract under its applicable laws as to what risk was assumed. There are no special conflict of laws rules which govern the consequences of inconsistency (if any).

The question of whether the governing law of the underlying insurance could have been ascertained by the parties at the time of entry into the contract (1977) was a very significant factor for all three Courts. It was this factor that persuaded the Lords that this case was distinguishable from case-law cited by Lexington, *Vesta v Butcher*² and *Groupama v Catatumbo*³. While Longmore LJ thought that the parties would have "*probably*" concluded that Pennsylvania law applied, the Lords did not agree. The Lords held that in 1977 when the contracts were concluded, there was no identifiable system of law applicable to the underlying insurance. Indeed, Lord Mance highlighted how

¹ Derived from *Hill v Mercantile & General Reinsurance Cp Plc* (1996) 1 WLR 1239 HL

² [1989] AC 852

³ [2000] 2 Lloyds Rep 350

surprising the decision that Pennsylvanian law applied to the contract must have been to the parties, by stating that on English Law principles Massachusetts law would have applied.

Therefore, despite the strength of the usual presumption that liability under a proportional facultative reinsurance was co-extensive with the underlying insurance, in this case the crucial question was whether the policy period clause in the reinsurance was to be given its English law meaning, or whether the parties were to be taken to have meant that the reinsurance was to respond to all claims irrespective of when the damage occurred and irrespective of the period to which the losses related. The Lords held that there was no principled basis for the latter contention. A reinsurance is an independence contract with its own terms which fall to be construed under its own governing law. To construe the policy in the way contended for by Lexington would be akin to interpreting the reinsurance as covering any liability which might subsequently be held to arise under the underlying insurance in any State, even though the law of that State might be applied by reference to factors extraneous to the underlying insurance. The existence of a 'follow the settlements' clause in a reinsurance does not extend the stated scope of cover, especially in relation to fundamentally important terms such as the period of cover.

Conclusions

In coming to their judgment, it appears that the Lords recognised the very real commercial difficulties that the Court of Appeal decision had created. By favouring Lexington's Pennsylvanian (all damage) interpretation, the Court of Appeal appeared to have undermined the period clause in the reinsurance, exposing Wasa to the same (huge) loss regardless of the period of cover. By reinstating the decision of the High Court, the Lords have removed a significant area of uncertainty for parties in a similar position.

In the Court of Appeal, Longmore LJ had some advice for reinsurers concerned about jurisdictional uncertainties in the Anglo-US arena. He suggested the use of the so-called "*Bermuda Form*" in which the parties agree to English or Bermuda arbitration but adopt New York law. Citing the recent *C v D4* case (in which Robin Simon LLP acted), he considered this would be a "*sensible arrangement*" which might avoid some of the problems in this case.

Lord Mance also touched on the question of what else Lexington could have done to reinsure themselves on a fully back to back basis. His suggested answer was to "*ensure that insurance and reinsurance are subject to one and the same identifiable or predictable governing law. Failing that, steps could at least be taken to make the insurance subject to an identifiable governing law, though this would not necessarily foreclose all argument.*"

While the legal interpretation to be applied to this particular reinsurance has now been finally clarified, the comments of Longmore LJ and Lord Mance show that the underlying lesson to be drawn from this case for the insurance market remains the same. Clear, consistent language in both insurance and reinsurance contracts and careful consideration of jurisdiction at the contracting stage is essential to avoid disputes of this type.

The case is also instructive for those writing risks such as FI/D&O policies or Professional Indemnity policies for firms with offices in many jurisdictions. A worldwide policy will usually be in place, but in many cases local policies from local insurers are also necessary to comply with local regulations. On these risks, it is likely to be impossible to make both the worldwide and all the local policies subject to the same choice of law. However, policy drafters need to be aware that the result of this is that there can be inherent difficulties in establishing whether and how the worldwide and the local policy will respond in the event of a claim, particularly if the claim itself involves more than one

jurisdiction. It would be prudent to ensure that both policies contain, at the very least, complementing provisions to govern the resolution of any coverage dispute between insurers.

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