Wasa v. Lexington: House of Lords Not Back-to-back With the Court of Appeal

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House of Lords considers the extent to which facultative reinsurance should be construed as being back to back with the underlying insurance.

The question of whether reinsurers whose reinsurance was for a three year period should be liable only for property damage occurring during that three year period or for the whole of its reinsured's loss, relating to over forty years worth of damage caused by the insured, has finally been resolved by the House of Lords. As we reported in the June 2008 issue of the *Insurance and Reinsurance Review*, the Court of Appeal had held that the reinsurers' liabilities were not so limited, because the reinsurance wording relating to the period of cover had to be given the same meaning as that in the insurance, as determined by the Supreme Court of Washington. The House of Lords, (which is to be reconstituted as the United Kingdom Supreme Court from 1 October 2009), has now rejected this view in *Lexington Insurance Company v AGF Insurance Limited* [2009] UKHL 40.

Background

The Respondent insurer, Lexington Insurance Company (Lexington) insured Aluminium Company of America and its subsidiary Northwest Alloys, Inc (Alcoa). Lexington obtained reinsurance with the Appellants, AGF Insurance Limited (AGF) and Wasa International Insurance Company Limited (Wasa). Alcoa incurred losses as a result of being required by the United States Environmental Protection Agency to fund the clear up of various contaminated sites occupied by Alcoa since the 1940s.

Alcoa then sought to obtain an indemnity from its various insurers, including Lexington, for these costs. It commenced proceedings in the State of Washington against its insurers; these proceedings ultimately resulted in a settlement by Lexington of $180million of claims made by Alcoa for $103million. It was common ground between the parties that this was a business-like settlement.

Lexington in turn sought to recover its losses from Wasa and AGF. The subject of the appeal to the House of Lords was whether Lexington could recover under the terms of its reinsurance with Wasa and AGF for the whole of its loss, being in respect of Alcoa's losses arising over forty plus years, or whether the reinsurers' liabilities were limited to those occurring during the three year policy period of the reinsurance.

The Insurance

The insurance provided by Lexington in 1977, was in respect of "*all physical loss of, or damage to, the insured property…*". It contained a Limit of Liability of $20million for loss or damage arising from any one occurrence, defined as "*any one loss(es), disasters(s), or casualty(ies) arising out of one event or common cause*". The policy term was three years beginning on 1 July 1977 and ending on 1 July 1980.

The Reinsurance

Wasa and AGF had a 2.5% line on the London market slip reinsuring Lexington. The slip expressed the interest to be "*All property of every kind and Description and/or Business Interruption and OPP &/or as original*". The policy period was expressed to be "*36 months at date 1.7.77 … and/or pro rata to expiry of original*". The sum insured was $20million each occurrence. The references in the slip to "*&/or as original*" under the headings 'Form' and 'Interest' were sufficient, the House of Lords said, to incorporate the relevant insurance provisions relating to the subject matter and risks into the reinsurance. The reinsurance was accepted to be governed, by implication, by English law due to the fact that it was on an English form and broked and issued in the London market.

Lexington's Liability to Alcoa

In the US proceedings, the judge at first instance had to consider claims for coverage against 70 insurers, involving hundreds of policies and 58 contaminated sites. As a preliminary issue the judge found that Lexington's insurance (and Alcoa's other policies) was governed by Pennsylvania law. The Supreme Court of Washington, reversing the lower court, held that Alcoa's insurers were jointly and severally liable for all Alcoa's losses which flowed from the contaminated sites even if the property damage occurred before inception of the policies. The Washington Court decided that the insuring clause was very broad and was not limited by the time of the physical loss or damage, consequently "*any physical loss or damage manifesting itself during the time a…policy was in effect was covered by the policy, including pollution damage starting before the policy inception*."

The House of Lords' Decision

The effect of the Washington Court's decision was that Lexington was liable for all damage manifesting itself during the three year period of insurance irrespective of whether the damage had begun prior to the inception of the policy. In essence, the question for the House of Lords was the extent to which the cover under a proportional facultative reinsurance contract is co-extensive with the cover under the insurance contract.

The Nature of Facultative Reinsurance

The House of Lords stated that the starting point for analysing the extent of the reinsurance is that proportional facultative reinsurance is normally back to back with the underlying insurance: the scope and nature of cover provided by the reinsurance is co-extensive with that of the insurance. The reinsurer takes a proportional share of the premium and accepts the risk of the same share of the insurer's losses. The 'obvious' commercial intention of proportional facultative reinsurance, the House of Lords said, is for the insurer to reinsure part of his risk and therefore it was equally obvious that the terms of the reinsurance should be construed to be consistent with the insurance.

Governing Law of the Insurance

The House of Lords stated that, in order to give effect to the principle in English law that the terms of the reinsurance should accord with those of the insurance, the question to be answered was what, in the reasonable contemplation of the parties at the time the contracts were entered into, was the governing law of the insurance policy. The Washington judge's decision that Pennsylvania law applied to the insurance contract was, said the House of Lords, to be viewed in light of the fact that she had to determine the issue with respect to a large number of insurers, insurance contracts and periods of insurance and light of a general consideration of the issues arising which were extraneous to the policy issued by Lexington.

Their Lordships determined, however, that in 1977 when the insurance policy incepted there was no identifiable, and thus no predictable, system of law applicable to the insurance by which the reinsurance, in turn, could have been construed to mean something other than its London market meaning, as determined by English law (as the governing law of the reinsurance). The Court was therefore able to distinguish the instant case from the appellate decisions in *Forsikringsaktieselskapet Vesta v Butcher* [1989] AC 852 and *Groupama Navigation v Catatumbo CA Seguros* [2000] 2 Lloyd's Rep 350 where in each case at the time the insurances and reinsurances were placed, the governing foreign law of the insurance contracts could be identified, thereby allowing the relevant reinsurers to interpret the terms of the reinsurance contracts.

The fact that the reinsurance was governed by English law meant, their Lordships said, that it did not have the same meaning and effect as that accorded to the insurance by the Washington Court. As a matter of English law, the reinsurance only covered property damage which occurred during the three years of the policy; this was "*clear beyond argument*". If, said Lord Mance, the position under the reinsurance was as found by the Washington Court then reinsurers would be liable for the whole of Lexington's losses even if the reinsurance was for a period less than that of the insurance; a result described by Lord Collins as "*wholly uncommercial and outside any reasonable commercial expectation of either party*".

Their Lordships therefore determined that there was no principled basis on which to find that the three year period of reinsurance should be treated as having the same scope as the insurance, as interpreted by the Washington Court

according to Pennsylvania law. The House of Lords were clear that whilst Lexington was unlikely to have bargained for the liabilities it was held by the Washington Court to have, that was no reason to pass that liability to Reinsurers who were entitled to believe no such liability could arise under the clear terms of the English law reinsurance contract. Having said that, their Lordships also made clear that insurers and reinsurers accept the risk of changes in the law and neither can complain that the scope of the insured's liability has been increased by judicial decisions.

Concluding remarks

Lord Mance suggested that in order to avoid the same result in future, insurers should ensure that the insurance and reinsurance are subject to the same governing law or at the very least that the insurance is subject to an identifiable governing law. This would make it more likely that the insurance and reinsurance will be considered back to back. Whilst this decision will come as a relief to reinsurers, it is once more, a salutary lesson to insurers and reinsurers to ensure that all the terms they wish to contract by, including the law governing their bargain, are clearly stated rather than leaving such matters to chance.