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REINSURANCE LAW – MIND THE GAP!

Wasa International Insurance Company Limited v Lexington Insurance Company and *AFG Insurance Limited v Lexington Insurance Company*

House of Lords: 30 July 2009

Introduction

Wasa v Lexington[1] was one of the final judgments of the House of Lords, delivered prior to the transfer of its judicial role to the new Supreme Court of the United Kingdom.

By overturning the judgment of the Court of Appeal, in many ways the decision may be seen as a farewell gift by the Lords to London market reinsurers, and the decision has been well received in London market.

But the House of Lords' judgment emphasises that reinsurance and insurance obligations do not necessarily operate 'back to back'. This creates a potential gap in reinsurance protection, particularly for any reinsured which issues insurance policies with a different proper law than that in its reinsurance contracts.

Facts

In very brief terms, Lexington (the Reinsured) had issued insurance policies to Alcoa for three years from mid-1977 to mid-1980, covering it for property damage in the USA. Alcoa was subsequently obliged by US law to remediate various industrial sites operated or previously operated by it in America. The sites had been contaminated over a period of about 30 years, stretching back to the end of the Second World War.

Alcoa asserted that under US insurance coverage law, Lexington was obliged to indemnify Alcoa for the full costs of remediation over the 30 year period, provided that at least some damage occurred at each site during the three years that Lexington was on risk. Lexington asserted that it was only liable to indemnify Alcoa for the damage to the sites which actually occurred during the three years Lexington was on risk, and that most of the damage had occurred before that time. The insurance coverage dispute was litigated in the USA.

The Supreme Court of Washington State (sitting en banc as a court of nine judges) found in Alcoa's favour. In doing so they applied US law to the insurance contract (the proper law of the contract being held to be the law of Pennsylvania). The consequence of this was that Lexington had an assessed liability to Alcoa of US$103million, and was found liable under the insurance policy, inter alia, for damage which occurred both before and after the policy periods.

Lexington then sought recovery from its reinsurers, including Wasa and AFG (the Reinsurers), of their share of the US$103million liability, under certain reinsurance contracts governed by English law and which contained a 'follow the settlements' clause.

The Reinsurers argued that, whatever may be the law of Pennsylvania, under English law the Reinsurers could only be liable for the costs of remedying damage to property which occurred from mid-1977 to mid-1980. They asserted the Reinsurers could have no liability for damage which occurred prior to or after the time they were on risk.

Trial and appeal

The reinsurance dispute was litigated in England. At first instance, before Simon J, the Reinsurers were successful. On appeal, however, the Reinsurers lost: per Longmore, Sedley

[1] [2009] UKHL 40.

and Pill LLJ. The Court of Appeal effectively found that the insurance and reinsurance contracts were intended to operate 'back to back'. The Court found that the Reinsurers were trying to give different meaning to the same terms in the insurance contract and the reinsurance contract, and that generally this ought not be permitted, even where each contract had a different proper law, because to do so would thwart the 'presumed intention' of back to back cover: see Longmore LJ at paragraphs 24, 25.

Longmore LJ also cited with approval the decision of *Vesta v Butcher*[2] and the words of Lord Templeman that 'the reinsurance policy is a contract by the underwriter to indemnify ... (the Reinsured) ... against liability under the insurance policy'. This is a perhaps another way of saying that the Reinsured's liability to the Insured under the original insurance contract is the 'springboard' of the reinsurance recovery, and the proper approach is to look first at the insurance coverage liability as determined by the proper law of the insurance contract, and not to ask what that liability would have been if English law had applied to the original insurance policy.

It was asserted by some commentators that the decision in *Wasa* was inconsistent with the House of Lords decision in *Hill v Mercantile & General*,[3] although the Court of Appeal was able to distinguish the case. The practical outcome in the Court of Appeal was adverse to London market reinsurers. They were obliged by the judgment to make reinsurance payments in respect of insurance claims to which US coverage law had been applied, when the application of English law to the primary insurance claims would have produced a different (and better) financial outcome for the reinsurers.

House of Lords judgment

The appeal in *Wasa* was heard by Lords Phillips, Walker, Brown, Mance and Collins. Each of their Lordships found in favour of the Reinsurers, and allowed the appeal. The principal judgments were delivered by Lord Mance and Lord Collins.

Subject matter of reinsurance

The different conclusions reached by the Lords and the Court of Appeal essentially related to differing views as to the subject matter of the reinsurance contract.

The Court of Appeal considered the contract of reinsurance as one to indemnify the primary insurer (the Reinsured) in respect of any liability incurred under the primary insurance. Under this analysis, because the Reinsured (Lexington) was liable to Alcoa under the insurance policies for damage occurring before and after the insurance period (as a result of the application of US law to the policies), then it was in respect of this liability that the Court of Appeal found the Reinsurers must provide indemnity under the reinsurance contracts (and even though English law would not, itself, have considered prior or subsequent damage to be covered).

However, the House of Lords disagreed.

Lord Mance found that:

> 'The well-recognised analysis which neither side gainsaid before your Lordships is that a reinsurance such as the present is an independent contract, under which the subject-matter reinsured is the original subject-matter.' (emphasis added)

Lord Phillips stated:

> 'Essentially the result of this appeal is dictated by the agreed fact that the reinsurance contract that is the subject of the appeal is governed by English law and by the well established principle, not challenged in this case, that under English law a contract of reinsurance in relation to property is a contract under which the reinsurers insure the property that is the subject of the primary insurance; it is not simply a contract under which the reinsurers agree to indemnify the insurers in relation to any liability that they may incur under the primary insurance – *British Dominions General Insurance Co Ltd v Buder*.' (emphasis added)

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[2] [1989] AC 852.

[3] [1996] 1 WLR 1239.

Lord Collins stated:

> 'For historical reasons the subject matter of reinsurance is treated as being the same as that of the original insurance. Lord Hoffmann said in *Charter Reinsurance Co Ltd v Fagan*[4] ... :
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> > 'Contracts of reinsurance were unlawful until 1864. Such a contract [of reinsurance] is not an insurance of the primary insurer's potential liability or disbursement. It is an independent contract between reinsured and reinsurer in which the subject matter of the insurance is the same as that of the primary insurance, that is to say, the risk to the ship or goods or whatever might be insured.' (emphasis added)

And, when English law was applied to the subject matter of the contract, the House of Lords found it only covered property damage which occurred during the three year reinsurance period. It emphatically did not cover property damage before or after that time (unlike the law of Pennsylvania). According to Lord Mance 'This is under English law clear beyond argument ...'.

Lord Walker held:

> 'Under English law nothing could be clearer than that a contract providing cover for loss and damage occurring during a specified-three year period could not be construed as covering in addition damage occurring before (or for that matter after) that three-year period.'

The result, then, was that because the reinsurance contracts were governed by English law, they only provided cover for the damage to property during the three year policy period; and they left the Reinsured exposed for all other liability visited upon it by the application of US law to the underlying policies. The presence of 'follow the settlements' clauses or a 'full reinsurance clause' would 'not have the effect of bringing within the cover of a policy of reinsurance risks that, on the true interpretation of the policy, would not otherwise be covered by it': per Lord Phillips.

The House of Lords also made clear that the result was achieved as a matter of construction of the reinsurance contract, and not as a matter of any conflict of law rule: see Lord Collins, at paragraphs 63, 94 and 108.

Commercial considerations

Whilst the technical analysis above was sufficient for the House of Lords to allow the appeal, it is clear that at least some of their Lordships were mindful of the commercial issues involved in the case.

Lord Collins of Mapesbury commenced his judgment by observing that:

> 'After banking, insurance is the United Kingdom's largest invisible export, of which reinsurance forms a large part.'

Whilst acknowledging that normally reinsurance – particularly proportional facultative reinsurance as involved in this case – should operate back to back with the underlying insurance, the Lords were obviously concerned about the negative financial impact on London market reinsurers of US insurance coverage decisions.

Lord Mance stated:

> 'At times during the argument, Mr Schaff submitted that no-one, even in the United States, could at the time of placement, have predicted that an American court would put on the insurance construction adopted by the Washington Supreme Court. It is unnecessary to express any view about the factual basis for this submission, although the cases themselves tell at least part of the story'

and also:

> 'Viewing the reinsurance through purely English law eyes, it cannot therefore be construed as a contract to indemnify Alcoa in respect of all contamination of Alcoa sites,

[4] [1997] AC 313.

> whenever caused or occurring, provided part of such contamination manifested itself or was in being during the reinsurance period. This would involve reinsurers in an unpredictable exposure, to which their own protections might not necessarily respond.' (emphasis added)

Of course, from the perspective of the Reinsured, the unpredictable exposure of concern to Lord Mance from a reinsurance perspective, would remain for it to bear alone.

Practical considerations for Australian Reinsureds and Reinsurers

The decision of the House of Lords raises a number of practical issues for Australian reinsurers and reinsureds.

At one level, there is the legal issue of whether *Wasa v Lexington* would be followed in Australia, or if the approach of the Court of Appeal would be preferred. No doubt it would be prudent to assume the decision of the House of Lords would be followed, at least from the perspective of an Australian insurer/reinsured, which wishes to mitigate any perceived 'negative' aspects of the case. Fundamentally, of course, a reinsured would be concerned if different systems of law govern insurance liabilities and insurance recoveries, with the resulting risk of an unreinsured '*Wasa*-style' gap in reinsurance protection.

Where an Australian insurer/reinsured seeks outwards reinsurance protection in the London market, the potential ramifications of *Wasa* should be borne in mind. Of course, since 31 December 2008 APRA requires that an Australian insurer must ensure the proper law of its reinsurance contracts is Australian law, with any dispute to be heard by an Australian court: see APRA Prudential Standard GPS 230 Reinsurance Management.

Nonetheless, the risk of a 'gap' still remains whenever a reinsured writes insurance policies governed by a different law to the law governing its reinsurance protection.

As stated by Lord Phillips in *Wasa*:

> 'The vital issue is, I think, reduced to this. Did the parties to the reinsurance implicitly agree that whatever law might be applied to interpretation of the primary cover, and whatever result this might produce, would apply equally to the reinsurance? An affirmative answer to this question would, effectively, treat the contract of reinsurance as one to indemnify the primary insurer in respect of any liability sustained under the primary cover. There might, as Sedley LJ considered, be much to be said for adopting this approach, and it is an approach that it would be open to the market, by appropriate contractual terms, to follow.'

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