Wasa v Lexington [2009] UKHL 40

Back to back?

It may have been thought safe to assume that cover under a facultative contract of reinsurance, incorporating the terms of the underlying insurance contract, and cover under the insurance contract, will be back to back, even if the laws by which they are governed differ. The long awaited decision of the House of Lords in Wasa[1] v. Lexington clarifies the limits to when this assumption may be relied upon.

The facts

Lexington issued an "All Risks Difference in Conditions" Property Damage Insurance Policy (the "**Policy**") to the Aluminium Company of America ("**ALCOA**") for the period 1 July 1977 to 1 July 1980.

The Policy was not subject to an express choice of law provision but contained a US Service of Suit clause, requiring Lexington, at the request of ALCOA, to "*submit to the jurisdiction of any Court of Competent Jurisdiction within the US*".

Lexington reinsured the risk covered under the Policy under a proportional facultative reinsurance contract (the "**Reinsurance Contract**"). The Reinsurance Contract, like the Policy, was for the period 1 July 1977 to 1 July 1980. It contained the following full reinsurance and follow the settlements wording: "*Being a reinsurance of and warranted same gross rate, terms and conditions as and to follow the settlements of the Company...*".

The parties agreed that the Reinsurance Contract was subject to an implied choice of English law.

In the early 1990s, ALCOA was required by the US Environmental Protection Agency to clean up pollution and contamination at various manufacturing sites used by ALCOA.

ALCOA sought to recover the costs from its insurers, including Lexington, with which ALCOA had cover in the period during which the damage had occurred - some fifty years dating back to 1942. ALCOA issued proceedings against these insurers in the State of Washington. The trial court in Washington found that the damage in respect of which ALCOA sought an indemnity had accrued over many years, including between 1977 and 1980. Therefore, the question arose of how the loss should be allocated between the different insurers and years of cover.

The trial court held that the law applicable to determining coverage was the law of Pennsylvania. The trial court further held that the loss could be allocated pro rata by dividing the total cost by the number of years during which the damage had accrued. Allocated in this way, the loss for which Lexington was held liable was only a small percentage of the total loss.

ALCOA appealed against the trial court's decision. On appeal, the Supreme Court of Washington held that the Insuring Clause of the Policy (in common with policies issued by other defendant insurers) covered losses arising from damage that had occurred before inception and during the policy period, provided only that the loss was "manifest" during the policy period. On this basis, the Supreme Court found the insurers, including Lexington, to be jointly and severally liable for the total loss suffered by ALCOA.

Facing a claim of some US$180 million, Lexington settled for just over US$103 million and sought to recover from its reinsurers. Wasa issued proceedings in the Commercial Court for a declaration that they were not liable on the basis that the Reinsurance Contract was governed by English law and, as a matter of English law, only covered losses occurring from 1 July 1977 to 1 July 1980. A large proportion of the loss in respect of which Lexington had been held liable and to which the settlement of ALCOA's claim related had occurred before this period and therefore did not, on Wasa's view, fall for cover under the Reinsurance Contract.

At first instance, Simon J found in favour of Wasa. This decision was overturned by the Court of Appeal, the decision of which was the subject of the appeal before the House of Lords.

The decision

The House of Lords (the leading judgment was given by Lord Collins) approached the issues raised by the appeal by recognising that the risk covered by a contract of proportional reinsurance will usually be co-extensive with the risk covered by the underlying insurance contract (absent any express indication to the contrary). This being the case, it may be assumed that the intention of the parties will be that wording of the reinsurance contract is to be interpreted as "back to back" with the insurance contract. However, a reinsurance contract is independent of the underlying insurance contract and liability under a reinsurance contract will therefore only arise in respect of risks falling within the cover created by the reinsurance. The position in this regard is not changed by follow the settlements wording. Therefore, Wasa could only be liable to Lexington if the loss in respect of which Lexington sought an indemnity fell within the cover created by the Reinsurance Contract.

In support of their position, Lexington relied on the decisions in *Vesta v Butcher* [1989] AC 852 and *Groupama v Catatumbo* [2000] 2 Lloyd's Rep 350. These decisions are authorities for the principle that, if a reinsurance contract and the underlying insurance contract are governed by different laws, the terms incorporated from the insurance contract into the reinsurance contract shall have the same meaning and effect as in the insurance contract.

The House of Lords considered that these cases only supported a principle of construction, to be applied only after taking into account all the relevant circumstances of the reinsurance. One key factor that distinguished the circumstances of *Wasa* from those of *Vesta v Butcher* and *Groupama v Catatumbo* was that, at the time the reinsurance contracts of concern in these earlier cases were entered into, the law by which each insurance contract was governed was readily ascertainable and would have been in the contemplation of the parties. By contrast, the Lexington Policy was **not** subject to an express choice of law. However, it was subject to a US Service of Suit clause and the property insured was located in a variety of different US (and non-US) jurisdictions. For these reasons, the House of Lords did not consider that the parties, at the time the Reinsurance Contract was entered into, could have ascertained under which law coverage under the Policy would be determined. Therefore, the reinsurers could not consult what was referred to in *Vesta v. Butcher* as a notional "foreign legal dictionary" to interpret the Reinsurance Contract in a manner differently from its ordinary meaning under English law.

The House of Lords rejected the suggestion that, because the Washington court had found that Pennsylvanian law applied in relation to coverage, this must, all along, have been the law applicable to determining questions of coverage. The basis for the House of Lords conclusion in this regard was that the Washington court's decision to apply Pennsylvanian law in relation to coverage had been driven by the requirement to adopt a law for this purpose that had a common connection with all the parties and sites involved in the litigation, which included many insurers other than Lexington and many jurisdictions. The Washington Court's decision to apply the law of Pennsylvania had been taken by reference to factors **extraneous** to the Policy.

Comment

The House of Lords ruling limits the application of the principle that, in relation to facultative contracts of reinsurance that are not governed by the same law as the underlying insurance, terms that the reinsurance incorporates from the underlying insurance are to be given the same meaning and effect as under the law by which the insurance is governed. According to Wasa, this principle will **not** apply if, at the time the reinsurance contract is entered into, the law by which the insurance contract is governed is not identifiable or ascertainable. This is because the reinsurer has no "foreign legal dictionary" to consult.

If you have any questions or require specific advice on any matter discussed in this publication, please contact Karen Abbott, Wendy Allen-Rodney, Ian McKenna, Carlos Fane or your regular contact at Mayer Brown.

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End notes

1 AGF, another reinsurer, was also a party.

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