House of Lords Hands Down Landmark Reinsurance Decision: Lexington Insurance Co. v. AGF Insurance Ltd.

Part II of a Two-Part Post

Introduction

In Part I we discussed the controversy surrounding the House of Lords decision in Lexington Insurance Co. v. AGF Insurance Co. [2009] UKHL 40. The House ruled that two proportional facultative reinsurers were not obligated to indemnify the cedent for their share of the entire amount of a judgment a Washington State court rendered against the cedent in an environmental coverage action. The judgment, which was based on Pennsylvania law, rendered the cedent liable under the policy jointly and severally for property damage caused by environmental contamination that occurred before, during and after the three-year policy period. The House ruled that the reinsurers could be held liable only for their respective shares of the loss that occurred during the three-year term of the reinsurance contract (which was concurrent with that of the cedent's policy), not their shares of the total amount of loss for which the Washington judgment held the cedent liable under the reinsured policy.

In this Part II we briefly summarize the pertinent background of the case, walk the reader through the House's reasoning and offer a few parting thoughts.

Background

The reinsurance contract, which was entered into in 1977, was ?back-to-back? ? i.e., materially identical to the reinsured policy ? save in one respect: the reinsurance contract was governed by English Law (because it was negotiated and entered into on the London Market) but it was unclear at the time of contracting which U.S. state's (or states') law would govern coverage issues in the event of litigation involving the policy. There was no choice-of-law clause in the policy (though there was a standard, service-of-suit clause), and choice of law would accordingly depend on where the action was brought, the facts, the issues, and applicable choice-of-law rules. As is typically the case in policies not containing choice-of-law clauses, all of these were imponderables at the time the parties entered into the contract, and would remain so until a coverage action arose concerning the policy, and a court ruled on choice of law.

Decision of the House

The House explained that whether or not the reinsurer had to pay its proportional share of the entire judgment was informed by some established principles of English reinsurance and insurance law. First, ?a reinsurer cannot be held liable unless the loss falls within the cover of the underlying insurance contract and within the cover created by the reinsurance,? and ?what falls within the cover of a contract of reinsurance is a question of construction of that contract.? Id. at ¶ 59 (Collins, L.J.). Second, there is a presumption that the coverage of a back-to-back proportional facultative reinsurance contract is coextensive with that of the cedent's policy. Id. at ¶¶ 60-73. Third, ?where an insurance or reinsurance contract provides cover for loss or damage to property on an occurrence basis, the insurer (or reinsurer) is liable to indemnify the insured (or reinsured) in respect of loss and damage which occurs within the period of cover but will not be liable to indemnify the insured (or reinsured) in respect of loss and damage which occurs either before inception or after expiry of the risk.? Id. at ¶ 74.

To determine the scope of the reinsurers' obligation the House had to construe two key contract provisions: (a) a ?Period? clause, which said that the reinsurance contract was in effect for a three-year period running concurrently with the three-year policy period; and (b) a standard ?Full Reinsurance Clause,? which contained a follow-the-settlements provision. The ?Full Reinsurance Clause? stated, in pertinent part:
Being a reinsurance of and warranted same gross rate, terms and conditions as and to follow the settlements of the Company. . . .

Id. at ¶ 21 (Mance, L.J.).

As a threshold matter, the Court had to decide whether the general rule that the coverage of the reinsurance contract was coextensive with the insurance contract applied in this case, where each contract was governed by different bodies of law, one determinate, and one indeterminate. That involved not the application of conflict-of-law rules, but construction of the contract. See id. at ¶ 63 (Collins, L.J.). The question boiled down to ?what law would the parties have expected would be applied by a court in the United States had [the insured] taken advantage of the Service of Suit clause, and in particular would the parties to the reinsurance contract have reasonably had in mind that what losses were recoverable under the insurance contract would be determined ultimately by the law of Pennsylvania?? Id. at ¶ 95. Because even though the joint and several liability allocation theory had not been devised by any court back in 1977 -- let alone adopted by the Pennsylvania courts -- both the insurer and the reinsurer assumed ?the risk of changes in the law.? Id. at ¶ 110. And if the parties reasonably expected that Pennsylvania law would apply, then the ordinary rule concerning back-to-back reinsurance would apply, and the reinsurer would be bound to pay its proportional share of the entire judgment, even though English law governed the reinsurance contract, and under English law the reinsurance contract would not ordinarily be interpreted to cover loss occurring outside the term of the contract.

But the Court found that the general rule was not applicable, because, at the time of contracting, there ?was no identifiable system of law applicable to the insurance contract which could have provided a basis for construing the contract of reinsurance in a manner different from its ordinary meaning in the London insurance market:?

I consider that it is fanciful to suppose that in 1977 the hypothetical American lawyer asked to advise on what law governed the contract of insurance, and what law would govern questions of coverage, would have concluded that Pennsylvania law would have applied. To have reached that conclusion the lawyer would have had to advise or assume that (a) there would be claims based on damage to several sites being litigated together; (b) plaintiffs in the environmental litigation would be most likely to sue in a State which applied the principles in the Restatement Second [of Conflicts of Law]; and (c) the courts of that State would apply those principles to conclude that the law which applied to the issues would be the law of Pennsylvania.

In my judgment, in complete contrast to Vesta v. Butcher and Groupama v. Catatumba, [, both of which applied the ordinary, back-to-back rule in situations where another jurisdiction's law governed the original insurance contract,] in the present case there was in 1977 no identifiable system of law applicable to the insurance contract which could have provided a basis for construing the contract of reinsurance in a manner different from its ordinary meaning in the London insurance market. In each of those cases, the substance of the foreign law as to the consequences of a non-causitive breach of warranty could be ascertained at the outset, if necessary by recourse to a relevant Norwegian (or Venezuelan) legal source.

Id. at ¶¶ 107-08 (citation omitted).

Accordingly, the Period clause had to be given the meaning that would be ascribed to it in the London insurance market. Pursuant to that clause, the reinsurance contract ?covered ?All Risks of Physical Loss or damage' and provided cover in respect of loss and damage occurring between 1 July 1977 and 1 July 1980. . . .,? and was therefore ?on the ?loss occurring' basis, under which a reinsurer is obliged to pay its share of the loss suffered by the reinsured, if it occurred during the period when the reinsurance contract was in force.? Id. at ¶ 76.

The Court found ?no principled basis for treating the scope of the 3 year reinsurance as the same as the insurance, which has been interpreted under the law of Pennsylvania not to contain any limitation as to time of the physical loss or damage to property.? Id. at ¶ 110 (citation and quotation omitted):

If [the cedent] were right, some very uncommercial consequences would flow if the reinsurers had agreed to accept only two years of the risk, rather than the three years of the underlying risk accepted by [the cedent], leaving [the cedent] to reinsure the third year of cover elsewhere; or if the London market had elected to reinsure Lexington by way of three separate one year policies . . . .The periods of cover under the insurance and reinsurances would not be back-to-back. But [the cedent] would still be maintaining that, in light of the decision of the Washington Supreme Court, if any damage occurred within any relevant policy period, of any duration, the relevant reinsurer would be liable for all of the damage, including damage occurring before inception or after expiry. That seems to me to be wholly uncommercial and outside any reasonable commercial expectation of either party.

Id. at ¶ 111.

The Court also rejected the cedent's argument that, pursuant to the follow-the-settlements language in the Full Reinsurance Clause, the loss is deemed to fall within the scope of the original insurance policy if ?so held by a court of competent jurisdiction, or if it is the subject of a settlement which cannot be impugned?:
The case for [the cedent] is not assisted by those authorities which decide that the reinsurer cannot go behind a determination of the reinsured's liability under the contract of insurance to the original insured, whether it is by way of settlement under a follow settlements clause or by the decision of a court of competent jurisdiction. The reason is that a reinsurer will only be bound to follow its reinsured's settlement and indemnify the reinsured provided that the claim recognised by them falls within the risks covered by the policy of reinsurance as a matter of law. This is because the reinsurer cannot be held liable unless the loss falls within the cover created by the reinsurance. Consequently the question remains the same: what is the effect of the policy period in the reinsurance?

Id. at ¶ 112 (citations omitted).

Finally, the House said that this case illustrated what it expected to be the exception, not the rule in cases involving back-to-back reinsurance:
I would also accept that it would almost invariably be the case that losses for which the insurer has indemnified the original insured would be within the reinsurance even if the losses are payable under a foreign law or a foreign judicial decision which takes a view different from English law of what losses are recoverable. The presumption that the liability under a proportional facultative reinsurance is co-extensive with the insurance should be a strong one because (as I have said) the essence of the bargain is that the reinsurer takes a proportion of the premium in return for a share of the risk. But this is an unusual case in which the express (and entirely usual) terms of the reinsurance are clear. This is not a case where the reinsurers are relying on a technicality to avoid payment. At the beginning and end of these appeals remains the question whether the provision for the policy period of the reinsurance is to be given the effect it has under English law, or whether the parties must 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. There is, in my judgment, no principled basis for a conclusion in the latter sense.

Id. at ¶ 116.

Some Parting Thoughts

The judgments in the Lexington case contain some impressive discussions of English law on the nature of reinsurance in general, back-to-back cover, the scope of a period clause, and follow-the-settlements. As we mentioned in Part I, it is a significant contribution to reinsurance jurisprudence. Its dissertations on English law concepts may, to some extent, influence the development of reinsurance law here in the U.S., where courts like the New York Court of Appeals sometimes cite and draw on the teachings of English courts.

But we do not think the aspect of the rationale on which the case turned will gain wide, if any, acceptance by courts or arbitrators here in the U.S. And that is the importance the Court accorded to the parties' lack of knowledge at that time of contracting of what law would likely govern coverage issues arising under the policy. We believe that both U.S. courts and arbitration panels will probably perceive that aspect of the decision to be overly formalistic, and not reflective of the expectations of the parties to a facultative, back-to-back reinsurance contract.

Had the parties to the Lexington reinsurance contracts been asked in 1977 whether the reinsurance contract was ?back-to-back? with the reinsured policy, we believe the answer would have been a resounding ?yes.? We doubt that the parties would have qualified their answer and pointed out that the reinsurance contract was governed by English, law while the insurance contract was governed by indeterminate U.S. law. And even had the reinsurer and insurer said that the contract was back-to-back, save in that one respect, we doubt that the insurer and reinsurer would, in turn, conclude that, in the event a U.S. court interpreted the terms of the policy more expansively than an English court might, then the reinsurers would not be required to pay their respective shares of the entire amount of the U.S. judgment.

The House strongly implied that, had the parties reason to know that Pennsylvania law would govern the interpretation of the policy's scope of coverage, then the reinsurers would have been responsible for their respective shares of the Washington judgment. The House said that it would be irrelevant that Pennsylvania had not yet adopted joint and several liability back in 1977, because changes in the governing law are a risk that both the insurer and the reinsurer accept. So the House presumably would have ruled for the cedent had there been, say, a Pennsylvania choice-of-law clause in the contract, even though neither the reinsurer nor the cedent had, at the time of contracting, any reason to believe that the policy might one day be interpreted to cover loss occurring outside the policy period, and even though in 1977 a Pennsylvania court probably would have interpreted the insurance policy to cover only loss occurring during the policy period.

A U.S. court or arbitration panel would probably question why the result should be any different simply because neither the insurer nor the reinsurer had knowledge at the time of contracting of what particular state's law would govern scope of coverage in some future coverage action. The reinsurer, by agreeing to reinsure a U.S. policy with a service-of-suit clause knew or had reason to know that: (a) the laws of any number of U.S. jurisdictions might be applied to particular issues arising in a coverage case; (b) those laws might or might not be different than English law concerning the policy's scope of coverage; (c) those laws might change; and (d) neither the cedent nor the insured could predict with any certainty what law might be applied to the policy, let alone what that law would ultimately provide at the time of some future coverage action. In other words, the reinsurer's guess as to what law might be applied to the policy in a future coverage action, and the ensuing result, was as good as the cedent's and the insured's.

Given that all parties were equally in the dark about all of this, we believe many U.S. courts and arbitration panels would consider the risk that the terms of the policy might one day be subject to the laws of a U.S. jurisdiction that construed them differently than English law might to be a risk that a back-to-back, proportional facultative reinsurer accepts when it enters into a back-to-back reinsurance arrangement with a U.S. cedent.

We also do not believe that many U.S. courts or arbitration panels would be persuaded by the House's suggestion that a ruling contrary to that in Lexington would render the period clause of the reinsurance contract meaningless. The House suggested that the cedent's position would have been the same had the reinsurers entered into three, separate, one-year reinsurance contracts reinsuring the three-year term of the policy. While that argument has at first blush a logical ring, it doesn't fare as well under scrutiny. First, if there were three, separate one-year reinsurance contracts spanning the term of the policy, then the reinsurance would, by definition, not be back-to-back cover, and there would be no reason to construe the period clauses in the insurance and reinsurance as having the same meaning. Second, consistent with the parties' reasonable expectations, the period clause of the policy could reasonably be deemed to have the meaning that the Washington Court accorded it under Pennsylvania law (i.e., as covering loss occurring before, during and after the three-year policy period), and the period clause of each one year reinsurance contract could reasonably be interpreted to cover one-third of the total amount of loss that the Washington Supreme Court deemed covered by the policy. Since the loss deemed to be covered by the Washington Supreme Court was of a continuous, indivisible nature, it would be reasonable to assume that, under the Washington court's judgment, one third occurred during the period the first, one-year reinsurance contract was in effect; one third during the term of the second, one-year reinsurance contract; and one third during the term of the third, one-year reinsurance contract. The terms of the period clause could reasonably be given further meaning by permitting the reinsurers the benefit of a retention each year (absent contract language providing otherwise).