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IN THE HIGH COURT OF JUSTICE
QUEEN'S BENCH DIVISION
Commercial Court

Royal Courts of Justice
Strand, London. WC2A 2LL

25 April 2007

B e f o r e :

Mr Justice Simon

Between:

Wasa International Insurance Company Limited	**Claimant/Part 20 Defendant**

and

Lexington Insurance Company	**Defendant/Part 20 Claimant**
And between:	
AGF Insurance Limited	**Claimant/Part 20 Defendant**
and	
Lexington Insurance Company	**Defendant/Part 20 Claimant**

Mr Alistair Schaff QC and Ms Sioban Healy (instructed by Addleshaw Goddard) for Wasa
Mr Neil Calver QC and Mr Stephen Midwinter (instructed by Charles Russell LLP) for AGF
Mr John Lockey QC (instructed by Chadbourne & Parke) for Lexington

Hearing dates: 13-15 February, 25 April 2007

HTML VERSION OF JUDGMENT

The Hon. Mr Justice Simon: Introduction

1. In this litigation, the respective Claimants ("Wasa" and "AGF") seek declarations that they are not liable to indemnify the Defendant ("Lexington") under a contributing facultative reinsurance contract ("the Reinsurance Contract") in respect of Lexington's underlying insurance of Aluminum Company of America ("Alcoa"). Lexington counterclaims for an indemnity or damages in respect of a settlement which it reached with Alcoa, and legal costs incurred by it in defending Alcoa's claim.

2. The period of reinsurance cover was 36 months from noon on 1 July 1977 until noon on 1 July 1980. These dates were intended to coincide with the period of the underlying insurance. The subject matter of both the reinsurance and the insurance was the risk of physical loss and damage occurring to property at Alcoa's worldwide sites.

3. Environmental damage was sustained at a number of Alcoa sites in various states of the United

States during the relevant three year period. The damage arose out of continuing failures on Alcoa's part in respect of the escape of waste products and the failure of manufacturing units to contain pollutants. The relevant causative acts and omissions of Alcoa first occurred and first began causing damage in 1942 and continued at least until 1986.

4. Alcoa began proceedings against a large number of insurers (including Lexington) in the courts of the State of Washington. On 4 May 2000 the Washington Supreme Court ('the Supreme Court') reversed the findings of the Superior Court; and held that, as a matter of Pennsylvania law, Lexington's insurance of Alcoa was to be construed as rendering Lexington jointly and severally liable for the remedial costs of cleaning up all the environmental damage at various specified sites.

5. Following the judgment, and after various unsuccessful attempts to reduce its financial impact, Lexington settled Alcoa's claims. The settlement, which forms the subject matter of the present action, was made on the basis that the insurance covered the cost of cleaning up environmental damage at the relevant sites, irrespective of whether the damage had been sustained before, during or after 1 July 1977 to 1 July 1980.

The Contracts

Insurance Contract

6. Lexington insured Alcoa (of 1501 Alcoa Building, Pittsburgh, Pennsylvania) in respect of loss or damage to property (and business interruption risks) under a Policy on Lexington's Special Floater form signed and dated at Boston, Massachusetts on 22 August 1977. The insurance, referred to as a DIC (Difference in Conditions) Insurance, provided for the insurance of Alcoa from noon on 1 July 1977 until noon on 1 July 1980. The Limit of Liability was stated to be:

> $20,000,000 loss or damage arising from any one occurrence.

The 'occurrence' was defined as:

> ... any one loss(es), disaster(s), or casualty(ies) arising out of one event or common cause;

and there was a property damage deductible of $250,000 per occurrence.

7. Although there was no express choice of law clause, the Insurance Contract contained a standard US Service of Suit clause:

> In the event of the failure of this Company to pay any amount claimed to be due hereunder, [Lexington] at the request of the Insured, will submit to the jurisdiction

of any Court of Competent jurisdiction within the United States and will comply with all requirements necessary to give such Court jurisdiction and all matters arising hereunder shall be determined in accordance with the law and practice of such Court.

Reinsurance Contract

8. The reinsurance incepted at noon on 1 July 1977 and provided cover in respect of all risks of physical loss or damage to the property reinsured occurring in the period of 36 months from 1 July 1977, subject to a limit of $20,000,000 per occurrence. The terms were set out in a Slip:

TYPE:	CONTRIBUTING FACULTATIVE REINSURANCE
FORM:	Jl. or NMA 1779 covering All Risks of Physical Loss or Damage excluding Fire and Allied Perils &/or as original.
REASSURED:	LEXINGTON INSURANCE COMPANY
ASSURED:	ALCOA ALUMINIUM
PERIOD:	36 months 1.7.77 L/U &/or pro rata to expiry of original.
INTEREST:	All Property of every kind and Description and/or Business Interruption and O.P. P. &/or as original.
SUM INSURED:	Policy to pay up to $20,000,000 each occurrence and in the aggregate annually in respect of Flood and Earthquake
SITUATED:	Worldwide &/or as original
CONDITIONS:	Retention $1,675,000 subject to excess of Loss &/or Treaty R/I Full R/I Clause No. 1 amended C.C. as original plus 30 days
PREMIUM:	Calculated at GOR
BROKERAGE:	25% and tax

The 25% brokerage was divided, with 10% payable to Lexington and 15% to CE Heath as brokerage.

9. On 1 June 1977 Sentry Underwriting Agencies Ltd subscribed to a 2.5% line of the Reinsurance Contract. WAS A is the successor in title to 1% and (for present purposes) AGF accepts that it is the successor in respect of **1**.5%.

Features of the Reinsurance Contract

10. It is convenient to identify certain features of the Reinsurance contract.

i) The risk was placed in London with London reinsurers by London insurance brokers in 1977, prior to the coming into force of the Rome Convention. It is common ground that the governing law is to be determined in accordance with English common law principles. It is also common ground that by the proper application of those principles, the Reinsurance Contract is governed by English Law, since the contract was broked in the London Market on one of two alternative London forms. It follows that the construction and legal effect of the Reinsurance Contract is governed by English Law.

ii) Since it appears that no contract was ever drawn up, it is common ground that the terms of the Reinsurance Contract are contained in the Slip.

iii) The Slip refers to a choice of forms (Jl or NMA 1779). This reflects an administrative practice in the London market for the issue of formal policy documentation. The Jl form is a 'policy jacket' containing a policy, which is then put to various underwriters for subscription. The NMA 1779 form was generally used as an attachment to a Slip, obviating the need to issue a formal Policy.

iv) The Jl form contains the words:

> Being a reinsurance of and warranted same gross rate, terms and conditions as and to follow the settlements of the [reassured].

The NMA 1779 form does not have a follow settlements clause. However it contains an obligation:

> ... to pay or to make good to the Reinsured all such Loss as aforesaid as may happen to the subject matter of this Reinsurance, or any part thereof during the continuance of this Policy.

v) Although the 'Full R/I Clause No.l as amended' referred to in the 'Conditions' has not been identified, it is common ground that the 'Full R/I Clause No.l' was a standard clause used in the London market and that it was in the following terms:

> Being a Reinsurance of and warranted same gross rate, terms and conditions as and to follow the settlements of the ... Company and that said Company retains during the currency of this Policy at

> least ... on the identical subject matter and risk and in identically the same proportion on each separate part thereof, but in the event of the retained line being less than as above, Underwriters' lines to be proportionately reduced.

Since the Jl form contained a similar provision, it can reasonably be inferred that the Full Reinsurance clause was specifically referred to in the Slip in the event that the NMA 1779 form was used.

vi) There is no express clause in the Reinsurance Contract which provides an indemnity to Lexington in respect of legal costs incurred in defending claims brought under the original Insurance Contract.

The insurance claim and the settlement

11. In the early 1990s the US Environmental Protection Agency and various state environmental agencies required Alcoa to clean up pollution and contamination of groundwater, surface water and soil at numerous manufacturing sites in the United States used by Alcoa. On 2 December 1992 Alcoa began proceedings in the Superior Court of the State of Washington (King County) against various insurance companies which had provided liability or all risks property insurance to Alcoa during the period 1956-1985. In this litigation Alcoa sought a declaration of entitlement to insurance coverage in respect of the clean-up costs at 35 manufacturing sites in the USA. Lexington was one of the defendants. A second action against first party property carriers, including Lexington, was commenced on 31 May 1996 in relation to 23 manufacturing sites worldwide. The two actions were subsequently consolidated.

12. The Superior Court selected 3 of the 58 manufacturing sites, Massena in New York, Vancouver in Washington State, and Point Comfort in Texas ("the Phase 1 test sites") to be the subject of an initial trial, with trials on the other sites to follow. In March 1996 the Phase 1 trial commenced before a jury. In due course most of the insurers sued by Alcoa were found not to be liable, either because the claim was time barred under suit limitation provisions in the policies or because the losses were excluded by pollution exclusions.

13. The trial then moved on to the second stage at which evidence was heard as to the existence, the extent and the time of occurrence of damage at each of the Phase 1 test sites. At the conclusion of the evidence the jury were provided with a Verdict Form containing 13 questions, and with written instructions on each question.

i) Question 1 required the jury to answer "yes" or "no" to the question whether

there was property damage at each area of each of three Phase 1 test sites.

ii) Question 2 required the jury to identify each year in which property damage occurred at each area of the three sites under headings: 1977-1978, 1978-1979 up to 1983-1984.

iii) Question 11 required the jury to state the costs of repair of fortuitous property damage at each area of each site without allocating repair costs to specific years.

iv) Question 12 asked the jury to say whether or not there was a reasonable basis to allocate to each separate policy year the costs related to the property damage that occurred during that year.

v) Question 13 asked, in relation to any damages and repair costs which the jury concluded could be allocated on a year by year basis, what portion of the total repair cost was attributable to the various policy years, with answers to be given either in percentage terms or dollar figures.

14. Other questions related to whether property damage was fortuitous and when Alcoa knew of the property damage. The jury instructions included the following in relation to Questions 12 and 13:

> The DIC policies issued by the Defendants cover only damage that occurred during the policy period. Therefore, if you find there are covered damages, once you have calculated the total costs incurred by Alcoa to repair, build, or replace its damaged property, you must determine whether the costs can be allocated to fairly and reasonably assign to each policy year the cost to repair the property damage which occurred during that year. Your determination must be based on the evidence and not on speculation or conjecture. If you find that it would be possible to allocate the costs of repairing the property damage, but the evidence does not provide you with an appropriate and reasonable method to do so, you should so indicate in response to Question No. 13 on the Special Verdict Form. If you find that the total repair costs are divisible over time, you will be asked to determine what amount of damages should be charged to each of the policy years as well as lump sum allocations for periods before and after the policy years. In allocating damage between years, you are not required to allocate 100% or the total to the insurers. If you find from the evidence that some or all of the damage occurred prior to or after the policy period, you may so allocated. If you do allocate a part or all of the damage to time periods other than July 1 1977 - July 1 1984, you need not allocate those damages by specific year.

15. The jury's verdict form was returned only partially completed on 3 October 1996, following 60 days of deliberations. The jury was then discharged. The verdict form included decisions that there had been property damage at most of the three Phase 1 test sites, which had occurred in each of the policy years and which contributed to the costs of repair (Questions 1 to 3). The jury

provided monetary figures for repair costs for some but not all of the areas where it had found that property damage had occurred, totalling just under US$20 million. However, the jury did not answer Questions 12 and 13, leaving blank these spaces on the form.

16. Following the jury's inability to reach a verdict on Questions 12 and 13, Lexington invited the trial Judge (Judge J. Kathleen Learned) to decide as a matter of law whether there was a 'reasonable basis or bases on which to allocate to each policy year the costs related to the property damage that occurred during that policy year'. In a ruling handed down on 3 March 1997, the Judge concluded as a matter of law that there was. She found that there were two occurrences: one was the wastage from the manufacturing units and the other was wastage which was independent of the manufacturing units. She held that the property damage at the 3 test sites could be measured and quantified in cubic yards and parts per million; and that the remedial costs were generally estimated, planned and priced according to the size of the contaminated area. Thus the damage that accrued during each policy year could reasonably and appropriately be equated with cubic yards of contamination that occurred during that year. Moreover, although the process of contamination was not entirely linear, it was the result of a continuous progressive process and yearly expansion was the 'inexorable rule.' This was a matter on which the experts were largely agreed. The Judge decided that 'a fair and appropriate estimation of the damage that occurred in each year can be attained by dividing the total damage by the number of years it took to reach its present border'; and that the damage was therefore divisible. She contrasted the pollution damage in Alcoa's case to cases of asbestosis, where the development of the disease was unrelated to the length of exposure or the number of asbestos fibres taken into the body.

17. The Judge further held that the total repair costs for a particular area should be divided by the number of years in which damage occurred. The damage occurring during any particular year would then be covered by such insurance policies as were on risk that year, with liabilities divided according to policy limits or 'other insurance' provisions of the policies. Alternatively, if the property damage should properly be characterised as indivisible, the court ruled that a *pro rata* allocation of damages rather than joint and several liability would still be appropriate.

18. Judge Learned's conclusion was expressed as follows:

> The Court finds progressive environmental damage of the type found at the three Phase 1 sites to be divisible as a matter of law and subject to allocation on a yearly basis. On the record produced at trial, the best estimate of actual damage is reached by simply dividing the damage over the time it took to develop, as reflected in Appendices A and B. In the alternative, if such damage is indivisible, the terms of the DIC contracts nevertheless require an allocation on a pro rata basis.

Appendix A set out actual damage at the three Phase 1 test sites, divided over the time the damage took to develop. It recorded that damage had occurred over substantial periods of time at all sites. At each site damage had occurred many years before the inception of the Insurance

Contract in 1977. For example, in the West Fill area at Massena, damage began in 1942 and continued until 1996 (over 54 years); and in the Landfill-East area at Vancouver, damage began in 1946 and continued until 1996 (over 50 years). The judge held that the appropriate method of allocation was to divide the total repair costs by the years in which the damage occurred. Applying this method in Appendix B, Lexington was under no liability in respect of Point Comfort and Vancouver where the repair costs were within Alcoa's deductible. Lexington's prima facie liability in respect of two occurrences at the Massena site was calculated to be $366,327.86. However, Lexington's liability for the three Phase 1 test sites was reduced to zero by the end of the trial as a result of other rulings in Lexington's favour on suit limitation.

19. Alcoa appealed the Judge's rulings on fortuity, suit limitation and allocation to the Supreme Court. On 4 May 2000 the Supreme Court (Judge Talmadge delivering the judgment of the court) handed down its judgment. In summary, the Supreme Court:

> i) held that Lexington was not entitled to rely on the suit limitation provisions in the Insurance Contract; and
>
> ii) reversed the judge's ruling on allocation, holding that the insurers were jointly and severally liable to Alcoa for all property damage, including damage which had occurred before the policies incepted.

20. In relation to the latter point the Court stated:

> The jury found pollution damage to all three test sites occurred during the entire time the various DIC policies were in effect. The jury also found, however, pollution damage had occurred to portions of the three sites prior to the inception of insurance coverage. Because the pollution damage occurred both before and during the various policy periods, a question arose as to how to attribute the remediation costs of the pollution damage: The jury was unable to reach a verdict on whether there is a reasonable basis or bases to allocate to each separate policy year costs related to the property damage that occurred during that policy year.
>
> At the conclusion of the trial, Alcoa filed a motion asking the trial court to hold as a matter of law the pollution damages were indivisible - that is, there was no way to distinguish between pollution damage occurring prior to policy inceptions and pollution damage occurring after policy inceptions. The trial court denied the motion, holding as a matter of law the pollution could be allocated on a pro-rata, yearly basis.
>
> ….
>
> Missing from the trial court's analysis of this issue is a close examination of the

> applicable policy language. The insuring clause of the DIC policy states: "Perils Insured: this policy insures against all physical loss of, or damage to, the insured property as well as the interruption of business, except as hereinafter excluded or amended." This language is very broad and contains no limitation as to the time of the physical loss of damage to property. There is no exclusion in the policy for physical loss or damage that may have begun spreading before the policy inception.
>
> The policy definition of occurrence likewise compels a broad reading of the policy: "The word 'occurrence' shall mean any one loss(es), disaster(s), or casualty(ies) arising out of one event or common cause(s)." There are no words of limitation here. It seems clear from the policy language that any physical loss or damage manifesting itself during the time a DIC policy was in effect covered by the policy, including pollution damage starting before the policy inception.

The Supreme Court then considered the case of *JH France Refractories Co* v. *Allstate Ins.* Co. 534 Pa, 626 A.2d 502 (1993), a decision of the Pennsylvania State Supreme Court in which the pro-rating approach in a case of asbestos disease was rejected. The Supreme Court noted the distinction drawn by the trial judge between asbestos disease . and environmental contamination, but stated:

> It may be true, as the trial court stated, that the progression of pollution damage can be measured and apportioned more certainly year to year than can the progress of asbestos disease, but that understanding begs the question of whether the express DIC policy language compels proration. It is the policy language that determines the scope of coverage. The policy language here does not provide for any limitations as to the scope of coverage .. .The insurers vigorously contend that while *J.H. France* may be correct as to third party coverage, it is not appropriately applied to first party coverage, citing the "all sums" language from the policy in *J. H. France.* We are not persuaded by this distinction. The language of the insuring agreement in the DIC policies is exceedingly broad, covering all physical loss or damage to Alcoa's property. This language is at least as broad as the policy language in *J.H. France.* Moreover, if DIC policies mean what the insurers claim they mean, the policy language should reflect that meaning. The policies in this case do not, and we decline to write a proration of coverage into the policies when the insurers failed to do so themselves. The trial court erred in its decision to prorate coverage according to the years the various DIC policies were in force. We reverse the trial court on this issue and remand the case for further proceedings relating to Alcoa's judgment for insurance coverage.

21. In §88 of his first witness statement, Mr Hassler of Steptoe & Johnson (Lexington's co-lead counsel in the Alcoa litigation) summarised the effect of the Supreme Court judgment:

> The [State] Supreme Court based its decision in part on the language found in the policies issued by [Lexington] and subject to reinsurance by Wasa. As the Court noted, the policy language does not exclude damage that may have been begun before a policy incepted. Similarly, the policy defines the term 'occurrence' without limitation to mean any one loss 'arising out of one event or common causes.' Finally, the [State] Supreme Court based its decision on policy language under which Alcoa was insured for 'all physical loss or damage' to its property.

22. Mr Schaff for Wasa submitted that the Supreme Court did not reverse the Judge's conclusion that the damage, and the cost of remedying the damage, was divisible over successive periods of time. The Supreme Court's approach was to accept the factual distinction drawn by the Judge between environmental damage and asbestosis, but to conclude that the Insurance Contract did not provide for the pro-rating of coverage. Its reasoning was based on the absence of any exclusion or limitation in the policy language in respect of damage which had occurred prior to inception: it did not specifically address the 'period' provision in the Insurance Contract.

23. For Lexington, Mr Lockey noted that neither of Wasa or AGF submitted that the Supreme Court's decision was perverse or irrational. The decision was based on the construction of the Insurance Contract provisions, applying Pennsylvania State law. The Court did not ignore the period provisions of the Insurance Contract. On the contrary the Supreme Court recognised and gave effect to the period provisions in the contract by the requirement that there be a relevant trigger during the policy period.

24. It is unnecessary to say anything further about the decision other than to note that US law is not uniform in this field. The New Jersey courts, for example, adopt the 'pro ration by exposure' approach which was argued to be the correct approach by Lexington in both the Superior and Supreme Court.

25. The action continued in the Superior Court, which ordered a re-trial of the 3 Phase 1 test sites in September 2003, and made directions for procedural steps culminating in a Phase 2 trial of the remaining sites to take place from June 2004. Various steps (described by Mr Hassler) were taken by Lexington to minimise the effect of the Supreme Court's decision on allocation; but these were largely unsuccessful and, shortly before the Phase 1 re-trial, Lexington entered into negotiations with Alcoa and agreed a settlement. A formal Settlement Agreement between Lexington and Alcoa was drawn up and dated 24 November 2003. Under the Settlement Agreement, the parties agreed to settle all past, present and future disputes under the Insurance Contract; and Lexington agreed to pay Alcoa US$103,140,500 in instalments between December 2003 and June 2005.

The present claim

26. On 30 January 2004 Lexington notified Heath Lambert Group (successors to the placing brokers for the Reinsurance Contract) that they had settled with Alcoa for US$103,140,500 and had

incurred and paid legal costs in defending Alcoa's claims. Following this Wasa and AGF began the present proceedings seeking declarations that they were not liable under the Reinsurance Contract.

27. Lexington's cross claims are:

    i) as against Wasa for:

        a) US$ 1,031,405, being 1 % of the settlement figure, and

        b) US$283,747.53, being 1% of the defence costs;

    ii) as against AGF:

        a) US$ 1,547,107.50, being 1.5% of the settlement figure, and

        b) US$452,621.30, being 1.5% of the defence costs.

The issues

28. (1) The principal issue in this litigation is whether the Reinsurance Contract requires Wasa and AGF to indemnify Lexington in respect of the settlement with Alcoa. In particular, whether it provides for an indemnity in respect of the remedial costs sustained in cleaning up the damage which occurred during the three year period specified in the Reinsurance; or whether it also requires them to indemnify Lexington in respect of the remedial costs sustained in cleaning up the damage which occurred prior and subsequent to the three year period?

    (2) There is a subsidiary issue in relation to the Retention: is there a one-off retention (as Lexington contend) or a per-occurrence retention (as Wasa and AGF contend)?

    (3) Finally there is an issue in relation to the costs of defending Alcoa's claim. Is there an implied term of the Reinsurance contract which enables Lexington to recover the costs of defending that claim (as Lexington contend) or not (as Wasa and AGF contend)?

The submissions on the principle issue

29. For Wasa, Mr Schaff QC submitted:

    i) Wasa reinsured Lexington in respect of the risk of loss and damage to the Alcoa plant for a three year period, not a fifty year period. The period of cover was fundamental to the scope of the bargain between reassured and reinsurer.

Notwithstanding the existence of a 'follow the settlement' provision and the decision of the Supreme Court as to the effect of Lexington's insurance contract as a matter of Pennsylvania law, Wasa did not contract to indemnify Lexington against any liability that might be incurred under the Insurance Contract. In order to be recovered the relevant loss must be within the scope of the Reinsurance Contract.

ii) If Wasa was correct in that overarching submission, two consequences followed.

a) Wasa was not bound to follow the Settlement Agreement since the settlement (and the claims recognised by the settlement) did not fall within the risks covered by the Reinsurance Contract as a matter of law.

b) Lexington's claim for indemnity failed since Lexington did not advance its claim against Wasa on the basis that, if the Reinsurance only responded to the cost of remedying damage caused during the three year period of cover, the cost of remedying that damage would (after exhaustion of the relevant retention and deductibles) give rise to a claim under the Reinsurance Contract.

30. For AGF, Mr Calver QC made broadly similar and supportive submissions to those of Mr Schaff.

31. For Lexington Mr Lockey QC submitted:

i) The Reinsurance and Insurance Contracts were intended to be, and were in fact, back-to-back.

ii) Although the Reinsurance Contract was governed by English Law and the Insurance Contract was not, that fact alone was not sufficient to disturb the back-to-back nature of the insurances.

iii) It was necessary to look at the Reinsurance Contract (and its factual background) in order to identify the presumed intention of the parties. On this basis the parties would have acknowledged:

a) the likelihood that disputes between Alcoa and Lexington (two companies incorporated in the United States) would have been litigated in the US; and might reasonably assume (since Alcoa was based in Pennsylvania and there was a favourable Service of Suit Clause) that a dispute would be decided in Pennsylvania under Pennsylvania State Law; and

b) the possibility that disputes might be decided in any US state forum and under any system of US state law.

iv) The Period Clause in the Reinsurance Contract was one of a number of provisions which reflected the back-to-back nature of the reinsurance; and there was no reason to read a limitation into the provision. In a facultative reinsurance there was no special feature of a period clause which required it to be treated differently to any other type of clause.

v) It was easily possible to formulate a declaration as to the extent of recovery under the Reinsurance Contract which could have been sought in 1977; and which would have been wide enough to embrace the sums which were claimed in this action.

vi) The Reinsurance Contract did not indicate with precision what was covered. It was the construction of the Insurance Contract which provided the definition of what constituted an occurrence and the financial consequences of there having been an occurrence; and it could have been anticipated that the scope of the original policy would be determined by the law of any state within the US.

vii) Where the meaning and effect of the terms of an insurance contract have been determined as between the insured and the insurer by a court of competent jurisdiction, the presumed intent of the parties to the Reinsurance Contract must have been that, in relation to the same claim, the same meaning and effect would bind the reinsurer, absent any provisions to the contrary in the Reinsurance Contract. Mr Lockey described this submission, based as it was on the judgment of the Court of Appeal in *Commercial Union Assurance Co. Plc and ors v. NRG Victory Reinsurance Ltd* [1998] 2 Lloyd's Rep 600, as 'an alternative and non-essential basis' for finding that Wasa and AGF were bound to follow Lexington's settlement.

Discussion

32. Before turning in detail to the law which applies in this case it is convenient to make some general observations about this type of insurance and reinsurance contract.

i) The effect of the Full Reinsurance clause is that the subject matter of the original risk is effectively incorporated into the reinsurance contract. To this extent the Insurance and Reinsurance Contracts are accurately described as 'back-to-back'.

ii) Just as it is common ground that the Reinsurance Contract is (and was at

inception) governed by English Law; so it is common ground that the Insurance Contract is (and was at its inception) governed by a system of law that was other than English Law. It follows that, although in many respects the Insurance and Reinsurance contracts were back-to-back, they were plainly not at least in this respect.

iii) The subject matter of the reinsurance was Alcoa's property. It was not a reinsurance of Lexington's liability to Alcoa under the Insurance Contract; see for example the analysis of Hobhouse LJ in *Toomey v. Eagle Star* [1994] 1 Lloyd's Law Rep 516 at 552, quoting Buckley LJ in *British Dominion General Insurance Co v. Duder* [1915] 2 KB 394 at 400.

iv) Under English law a reinsurer is not obliged to indemnify the reassured unless the loss falls within (a) the scope of the cover of the insurance contract; and (b) within the scope of the cover created by the reinsurance contract, see for example *Hill v. Mercantile & General Reinsurance Co Plc* [1996] Lloyd's Law Rep 341, Lord Mustill at p.350.1.

v) In the absence of any express clause in the reinsurance contract, it is for the reassured to prove both matters. However, the parties can agree how either or both matters may be proved; see again Lord Mustill in *Hill* v. *Mercantile* at p.350.1. A Follow Settlements clause is one way in which parties can agree on how the reassured proves these matters, see *Assicurazioni Generali* v. *CGU International Ins Plc* [2003] 1 Lloyd's Law Rep 725 (Mr Kealey QC) at §35.

vi) In reaching their bargain potentially conflicting considerations may have to be weighed: the undesirability of investigating and litigating the same issues twice, on the one hand; and the importance of ensuring that the reinsurer's bargain is not eroded by an agreement over which the reinsurer has no control, on the other. A Follow Settlements clause is intended to give proper weight to both considerations.

vii) Under a Follow Settlements clause a reassured does not have to prove that the loss actually fell within the scope of the insurance, only that it acted honestly in making the settlement and took all proper and business-like steps in settling the claim, see the second *Scor* (or proper and business-like steps) proviso, as described by Robert Goff LJ in *Insurance Co of Africa* v. *Scor (UK) Reinsurance Ltd* [1985] 1 Lloyd's Rep. 312 at p. 330.

33. In the present case it is common ground that in making the settlement with Alcoa, Lexington acted honestly and took all proper and business-like steps. The issue then is whether the claim, which was recognised by Lexington and which it wishes to pass on, fell within the risks covered by the Reinsurance Contract as a matter of law, see the first *Scor* (or scope of the reinsurance)

proviso, as described by Robert Goff LJ in the *Scor* case (see above).

34. The crucial matter for proof when considering the first *Scor* (or scope of the reinsurance) proviso is not that the original loss falls within the cover created by the reinsurance contract; but rather that the claim recognised by the reassured falls within the risks covered by the reinsurance contract as a matter of law, see the judgment of Mr Kealey QC in the *Generali* case (above) at §36. In such a case (§38):

> ... one is examining the claim recognised by the insurers by their settlement of it by admission or compromise and whether on that basis the claim falls within the reinsurance cover as a matter of law

35. In the present case the question is whether the claim recognised by the Settlement Agreement falls within the Reinsurance Contract as a matter of law; and, in particular, whether it is excluded by the defining terms of the Period Clause. The point was characterised by Evans J in *Hiscox v. Outhwaite (No.3)* [1991] 2 Lloyd's Law Rep 524 at 530.

> In my judgment, the reinsurer is always entitled to raise issues as to the scope of the reinsurance, and where the risks are co-extensive with those of the underlying insurance he is not precluded from raising such issues, even when there is a 'follow the settlement' term of the reinsurance contract. Ultimately, this is the only sure protection which the reinsurer has against being called upon to indemnify the reinsured against payments which were not legally due from him to the original insured, however reasonable and businesslike the payments may have been.

This passage was cited with approval by Tuckey LJ in the Court of Appeal in the *Generali* case [2004] 1 Lloyd's I & R Law Rep 457 at §16.

36. In *Municipal Mutual Insurance Ltd v. Sea Insurance Co Ltd* [1998] (CA) Lloyd's Law Rep. I & R 421 at 453, Hobhouse LJ (with whose judgment the other members of the Court of Appeal agreed) made it clear that reinsurance contracts 'were distinct and independent contracts under which the cover was defined by reference to the year of cover.' In that case the reassured had aggregated its losses over three yearly periods of insurance and sought to recover in full under the second of three yearly reinsurance contracts. At p.435.r. Hobhouse LJ observed:

> It is wrong in principle to distort or disregard the terms of the reinsurance contracts in order to make them fit in with what may be a different position under the original cover. The words 'conditions as underlying' cannot contradict either the period or limit provisions of individual reinsurance contracts.

He also noted that the Judge at first instance:

> ... came to the surprising conclusion that each reinsurance contract covered liability in respect of physical loss or damage whether or not it occurred during the period covered by the reinsurance contract and he went on expressly to contemplate that the same liability for the same loss and damage might be covered under a number of separate contracts of reinsurance covering different periods. This is a startling result and I am aware of no justification for it.

The general position was set out at p.436 of the judgment:

> When the relevant cover is placed on a time basis, the stated period of time is fundamental and must be given effect to. It is for that period of risk that the premium payable is assessed. This is so whether the cover is defined as in the present case by reference to when the physical loss or damage occurred, or by reference to when a liability was incurred, or a claim made. Contracts of insurance (including reinsurance) are or can be sophisticated instruments containing a wide variety of provisions, but the definition of the period of cover is basic and clear. It provides a temporal limit to the cover and does not provide cover outside that period; the insurer is not then 'on risk'

37. The Court of Appeal had been referred to a number of US decisions, including the case of *Keene Corp v. Insurance Co of North America 661* F2d 1034 which was decided in 1977 and was an early, if not the first, case to apply the joint and several approach to allocation adopted by the Washington State Supreme Court, see *Holmes' Appleman on Insurance* 2d Chapter 145.4. In relation to these cases, Hobhouse LJ said:

> ... the plaintiffs in support of their argument on construction cited a line of United States cases which adopt a different approach, in particular *Keene Corp v. Insurance Co of North America* 667 F2d 1034 and *Stonewall Ins Co* v. *Asbestos Claims Management Corp* 73 F3d 1178. Interesting though they are, I am not assisted by these cases. They arise from the special problems of liability for asbestosis claims arising from long periods of potential exposure and are clearly governed by policy considerations relevant to special factors affecting that part of the insurance market in the United States. I do not consider that they provide guidance for the much simpler questions raised by the present case which are already covered by established principles of English law and authority ... The correct approach is to see to what extent the plaintiffs have established that they are entitled to recover from the relevant defendants under ... the ... contracts of reinsurance.

38. The *Municipal Mutual* case provides strong support for the following propositions.

> i) A Period Clause in a time policy is of fundamental importance.

> ii) Ordinarily, the reassured must satisfy the court that there has been physical loss or damage which has occurred in the year covered by the relevant contract of reinsurance.
>
> iii) The fact that the insurance and reinsurance contract are expressed to be back-to-back 'as original' does not have the consequence that the natural meaning of a period clause in a time policy can be 'distorted' or 'disregarded'.

These are important points to have in mind when trying to establish the presumed intention of the parties and the proper construction of the Period Clause in the present case.

39. Turning to the terms of the Reinsurance Contract, it is significant that the parties agreed that the NMA 1779 wording, which provided that the reinsurer's obligation was

> to pay or make good to the reassured all such loss as aforesaid as may happen to the subject matter of this Reinsurance, or any part *thereof during the continuance of this Policy*, (emphasis added)

might be used. That the parties envisaged that such a term would be incorporated in the Reinsurance Contract militates against the construction favoured by Lexington.

40. I accept, as Mr Lockey submitted, that there are a number of features of the Reinsurance Contract which indicate that the parties intended that the contract was to be back-to-back with the Insurance Contract: for example, the premium being calculated at gross original rates. However Mr Lockey went further and submitted that the parties intended that the scope of the Period Clause in the Reinsurance Contract was the same as the scope of the Period Clause in the Insurance Contract. He relied in support of this proposition on *Forsikringsaktieselskapet Vesta v. Butcher* [1989] AC 852, and *Groupama Navigation et Transports and ors v. Catatumbo CA Seguros* [2000] 2 Lloyd's Law Rep. 350. He submitted that these cases demonstrated that, in the absence of clear words to the contrary, there is a presumption that the scope and nature of the cover afforded by reinsurance will be the same as the cover afforded by the insurance. They are put together as a package and it cannot have been intended that the same period wording in the two contracts should have a different meaning in each.

41. In *Vesta v. Butcher* the wording of a warranty in the English law reinsurance contract was held to have the same meaning and effect as the same words (the No.V wording) in the insurance contract interpreted as a matter of Norwegian law. Lord Lowry (with whom the other members of the House of Lords agreed) expressed his conclusion at p.911E:

> The parties to [the reinsurance contract] are deemed to have used the same dictionary, in this case a Norwegian legal dictionary, to ascertain the meaning of the terms and conditions in wording No.V, including the conditions relating to the

> 24-hour watch and the words 'failure to comply'. There is, in my view, no need to treat the reinsurance contract as partly governed by Norwegian law, except in the special sense that one must resort to Norwegian law in order to interpret and understand the meaning and effect of the No.V wording in both contracts.

Since the package was designed for use by Norwegian fish farmers, it could not have been intended that a breach of the No.V wording would give rise to one consequence under Norwegian law in the insurance contract and a different consequence under English law in the reinsurance contract.

42. In *Groupama* v. *Catatumbo* a warranty in a reinsurance slip was held, as a matter of the intention of the parties, to have the same interpretation as the same warranty in the original policy interpreted by Venezuelan law. Mance LJ, at §30, expressed his conclusion on the case as follows:

> In my judgment, the warranty of existing class maintained in the present reinsurance must take its precise meaning and application from any equivalent warranty incorporated in the original insurance, when as here (a) the two contracts were on their face intended to be back-to-back and moreover (b) the equivalent warranty was itself also incorporated in the reinsurance by the words "All terms, clauses, warranties ... as original". A harmonious result is thus achieved.

Tuckey LJ proceeded on the basis that there was,

> ... a presumption, in the absence of clear words to the contrary, that the scope and nature of the cover afforded [by the reinsurers] is the same as the cover afforded by the insurers (see §17);

and Mance LJ stated at §26:

> The reinsurance is however a contract which in terms relates to and must be read in conjunction with the terms of the original insurance. The two contracts were clearly intended to be back-to-back. As regards the vessel(s) covered, its period, its terms and all decisions, settlements and agreements, the reinsurance expressly follows the original...

However, Tuckey LJ (at §23) considered the issue was one of construction in each case rather than a question of overarching principle.

> At the end of the day each of these cases depends upon the construction of the contracts in question in their context and so each case (must) depend upon its own facts.

43. In the present case it seems to me that Mr Schaff is right in his submission that neither of these cases materially assists Lexington. Both cases involved inferring a contractual intention that terms incorporated in a reinsurance contract by reference to the underlying insurance were to have the meaning understood under the local law or language. In each case it would have been possible with the assistance of a legal encyclopaedia or dictionary to establish the meaning of the disputed words in the relevant reinsurance contract. The position is different in the present case. There was no identifiable US law interpretation that could be placed on the Period Clause; and I reject the submission that the period provision in this Reinsurance Contract can properly be construed by reference to the particular interpretation that was subsequently placed upon a similar period provision in the original insurance by a particular US State court, which happened to be seised of the underlying insurance dispute over twenty years later. Such a construction neither truly gives effect to the intention of the parties nor achieves a harmonious result. It would lead to a construction whose effect would be not so much back-to-back as back-to-front, see *CGU International Insurance v. AstraZeneca Insurance Co* [2006] Lloyd's Law Rep I &R 409 at §128.

44. At the time the Reinsurance Contract was made there was no certainty either as to where an underlying claim would be made or which law would be applied. There was certainly nothing inevitable about the Washington State Courts being seised of Alcoa's claim or that any court would apply Pennsylvania law. Unlike the reinsurance contracts in *Vesta v. Butcher* and the *Catatumbo* case, there was no US law interpretation of the Period Clause in 1977 which could be 'written into' the Insurance Contract and by reference to which one could infer that the parties to the Reinsurance Contract had contracted.

45. The Follow Settlements clause and the back-to-back nature of the insurance and reinsurance contracts are both important features of the reinsurance; but they are not sufficient to displace the importance of the prescribed period of cover. The Reinsurers in this case agreed to reinsure Lexington in relation to Alcoa's property damage occurring between noon on 1 July 1977 and noon on 1 July 1980, or to use the words of the NMA 1779 form, 'during the continuance of the policy'. The Reinsurers did not agree to reinsure Lexington in relation to an earlier or later period, nor in relation to its liability to Alcoa, nor in relation to a period of cover which might be determined by whatever US law interpretation might be placed on the period clause in the Insurance Contract. The importance of the finding of Judge Learned is that it was plainly possible, on the evidence she had heard, to identify damage which occurred during the policy period. This is not one of those cases where there was a dispute as to when damage occurred, so that Lexington might argue that a settlement was made on the basis that damage might have occurred during the policy period. This was a case in which Lexington settled the case on the basis that it was liable for the costs of remedying damage outside the period of cover because there had been (in the words of the Opinion of the Washington Supreme Court) 'no exclusion in the [DIC] policy for physical loss or damage that may have begun spreading before the policy inception.'

46. The Reinsurance Contract cannot be construed as if it provided cover in respect of the . cost of remedying damage whenever such damage occurred (both before and after the policy period) solely on the basis that some damage occurred within the policy period. As Lord Mustill expressed it in the *Hill v Mercantile* case:

> ... the reinsurers are entitled to say that they rated the policy by reference to its *chronological* and geographical *extent*, to the types of casualty insured, to the boundaries of the insured layer, the mode of calculating the loss, and so forth, (p.351.1. emphasis added)

47. Before leaving this issue it is necessary to address Mr Lockey's alternative and non essential submission based on the *Commercial Union* v. *NRG* case. In that case the Court of Appeal was dealing with the question of whether the assured had proved that it had suffered a loss under the insurance contract. This was described as 'the only question', see Clarke J at p.605r. The Court was not concerned with the separate question of whether the loss fell within the reinsurance. It certainly did not decide that a decision of a foreign court as to the construction and effect of an insurance contract bound the reinsurers as to the construction and effect of the reinsurance contract. In my view Mr Lockey's alternative submission is unsupported by authority and does not reflect the presumed intention of the parties in the present case.

48. It follows from the above that the loss claimed by Lexington is not a loss which fell within the Reinsurance Contract as a matter of English Law; and I therefore make the declaration sought by Wasa and AGF. At the request of Lexington, and with the agreement of the other parties, I leave open the issue of whether Lexington can make a claim under the Reinsurance Contract in respect of losses occurring within the 3-year period of the reinsurance.

The Retention issue

49. This issue, which only arises if Wasa and AGF are obliged to follow Lexington's settlement with Alcoa, is whether the $1,675,000 retention is a 'one-off retention (as Lexington contend) or a 'per occurrence' retention (as Wasa and AGF contend).

50. For Wasa Mr Schaff pointed out that the reinsurance cover is not an aggregate cover, save in respect of flood and earthquake. The reinsurance is 'to pay up to $20,000,000 per occurrence ...'; and in these circumstances it would be odd to have a one-off retention in what was primarily a per-occurrence reinsurance contract. He also observed that the underlying insurance had a per-occurrence deductible. Finally he relied on the way the matter was handled by the brokers. So far as this latter point is concerned it seems to me that it is not legitimate to construe the contract by reference to how an agent understood it to operate after the event; and I decline to do so.

51. For Lexington Mr Lockey drew attention to the fact that it was easily open to the parties to have inserted the words 'per occurrence' in the conditions clause so that it read 'Retention $1,675,000

per occurrence subject to excess of loss and or treaty R/l'. More persuasively, he submitted that, as a matter of general impression, if Lexington was agreeing to retain the first $1,675,000 of loss on every occurrence (which might be thought to be the 'sharp' end of the cover) then one would not expect the reinsurers' premium to be a share of the gross original premium

52. The resolution of this issue is very much a matter of impression; and on balance it seems to me that Mr Schaff is right on this point and for the primary reason he advanced. The fact that a provision could have been made clearer by the use of language, although undoubtedly true, does not advance the matter greatly in this type of case.

The costs of defending Alcoa's claim

53. Again this issue only arises if Wasa and AGF are obliged to follow Lexington's settlement with Alcoa. Lexington incurred substantial costs (US$27,518,883) in defending Alcoa's claims. It seeks to recover a proportion of such costs from Wasa and AGF.

54. Mr Lockey submitted that the essential structure of a proportional facultative reinsurance contract is that the subscribing reinsurers share in the fortunes of the reassured and that losses are borne between the reassured and the reinsurer in their respective proportions. He accepted, as he must, that the House of Lords in *Baker v Black Sea & Baltic* [1988] 1 WLR 974 rejected the implication of a term permitting recovery of defence costs under a quota-share reinsurance; but argued that there were significant differences in the present case. First, Wasa and AGF were, in substance if not in form, co-insurers of Lexington. Secondly, there was no overriding commission in the Reinsurance Contract from which Lexington could meet the defence costs. Thirdly, the effect of implying the term would not, as it did in the *Scor* case, take the reinsurer's liability beyond its contractual maximum as expressed in the reinsurance wording since there is no such maximum in the present contract. Finally, Mr Lockey submitted that there would be no injustice to Wasa or to AGF if a term were implied such as to enable Lexington to recover the defence costs, provided that Wasa and AGF remained liable for no more than their respective percentages of the US$20,000,000 per occurrence limit.

55. In my judgment there is a formidable objection to Mr Lockey's argument: it is contrary to all authority. In *Baker* v. *Black Sea & Baltic General Insurance Co Ltd* [1998] 1 WLR 974, the House of Lords held that, in the absence of either express provision or a universal market practice in the relevant market, reinsurance contracts do not provide cover for expenses incurred by the reinsured in defending claims. The House unanimously rejected a submission that a term requiring the reimbursement of expenses should be implied into proportional reinsurances. The reasons were set out in the speech of Lord Lloyd of Berwick at pp.979-982 (adopting the judgment of Millett LJ in the Court of Appeal at [1996] 1 Lloyd's Reinsurance Law Rep 353, at 362-3). In the present case, the Reinsurance Contract contains no express provision for the coverage of expenses; and Lexington has not attempted to prove a universal practice in the London market in 1977. Furthermore, the reinsurance is a facultative, non-proportional

reinsurance. None of the partnership-like qualities of proportional reinsurance, which had been relied upon by the reinsured in *Baker* v. *Black Sea* in support of the argument for an implied term, apply to the present case. In the circumstances, the reasons for rejecting the existence of an implied term apply to the present case with increased logical force.

Conclusion

56. I therefore conclude that:

    i) Wasa and AGF are not obliged to follow Lexington's settlement with Alcoa; and

    ii) in any event,

        a) the $1,675,000 retention is a 'per occurrence' retention, and

        b) Lexington is not entitled to recover against Wasa and AGF in respect of the costs of defending the claim of Alcoa

57. I understand that (subject to the issue of costs) the parties will be able to agree an order in the light of these conclusions.
