THE LIMITATIONS OF 'BACK TO BACK' AS A CONCEPT IN REINSURANCE IN ENGLISH LAW

Lexington v AGF (and Lexington v WASA) (2009)

Background

Writing towards the end of the 18th Century, at a time when reinsurance contracts were prohibited in England by statute[1], Park J said "Re-assurance, as understood by the law of England,[2] may be said to be a contract which the first insurer enters into, in order to relieve himself from those risks which he has incautiously undertaken, by throwing them upon other underwriters, who are called re-assurers."[3]

Historically there has been some discussion on whether reinsurance actually constitutes a form of liability insurance contract whereby the re-insurance insures the liability of the cedant or is indeed a different specific type of contract that is properly called "reinsurance", the distinguishing feature of which is that the subject matter of the reinsurance is treated as being the same as that of the original insurance.

In England, Lord Mansfield answered that question 200 years ago: "... a reinsurance, ... consists of a new assurance, effected by a new policy, on the same risk which was before insured, in order to indemnify the underwriters from their previous subscription and both policies are in existence at the same time".[4] Lord Hoffman affirmed this recently in *Charter Reinsurance Co Ltd v Fagan*[5]: "... Contracts of reinsurance were unlawful until 1864. Such 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. The difference lies in the nature of the insurable interest, which in the case of the primary insurer arises from his liability under the original policy ...".

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[1] The Marine Insurance Act 1745; and thus apparently also in the overseas territories of His then Majesty (George II) including those which later founded the USA following the War of Independence. Reinsurance was legalised in England in 1864.

[2] There is no such thing as "UK law" or "British law". Scotland and Northern Ireland are separate jurisdictions (though they share the same highest appellate Court – see below). Wales is part of "England and Wales", conventionally contracted (by the English anyway) to "England"/"English". Jersey, Guernsey and the Isle of Man are part of Her Majesty's territories but not technically part of the United Kingdom and like all such territories their highest appellate Court is (the Judicial Committee of) Her Majesty's Privy Council.

[3] Quoted in A System of the Law of Marine Insurances (8th Edition, Professional Books, 1842 reprinted 1987), page 595.

[4] Delver, Assignee of Bunn v Barnes (1807) 1 Taunt 48.

[5] (1997) AC 313, at 392.

In other words, even a perfectly proportional facultative reinsurance is not an insurance against liability, and ipso facto not one against any liability which the reinsured may incur under his own insurance. Accordingly, one of the perennially vexed questions which arises in reinsurance is the extent to which a reinsurer is liable to pay the losses suffered by the reinsured.

"In proportional reinsurance the reinsurer or reinsurers accept a specified percentage of the risk and receive the same percentage of the gross premium or 'gross/net premium' as it is quaintly called – the premium to the reinsured net of commission paid by him. The fortunes of the reinsured and the reinsurer, on the business written should, proportionately, be the same".[6]

In order to ensure that the fortunes are indeed the same, in other words that reinsurances do respond properly to losses properly paid by reinsureds, English law has developed a substantial body of case law.

Follow the fortunes

In *Insurance Company of Africa v Scor (UK) Reinsurance Co Limited*[7], the Court of Appeal laid down that where a reinsurance contract contains a "follow the settlements" clause, in any case in which the cedant insurers can establish that (1) the claim falls as a matter of law within the risks covered by the reinsurance policy[8]; (2) they have acted in good faith and without fraud or collusion; and (3) they have acted "in a proper and businesslike manner", the reinsurers must pay their proportion of the claim.

Such a clause is frequently, indeed usually, to be found in London market facultative reinsurance contracts. It is often incorporated within what is called a "full reinsurance clause".[9] Such a clause tends to be regarded as "an essential part of the facultative reinsurance policy".[10]

The use of such shorthand is part and parcel of normal London market practice. Although as time has gone by, the law has developed, brokers have become more cautious and Lloyd's and the company market more demanding, the length of placement slips in the London market has expanded, they remain succinct, using such market shorthand. Certainly in the 1970s, even the largest reinsurance contracts might be written on slips of 100 or 200 words.

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[6] O'Neill & Woloniecki, The Law of Reinsurance (2nd Edition), para 1-11.
[7] (1985) 1 Lloyd's Rep 312; (1983) 1 Lloyd's Rep 541 at first instance.
[8] Or arguably so – Assicurazioni Generali SpA v CGU International Insurance Plc (2004) Lloyd's Rep IR 457.
[9] "being a reinsurance of and warranted same gross rate terms and conditions as and to follow the settlements of ..."
[10] Kiln, Reinsurance in Practice (4th Edition, Witherby 2001) page 12.

Of course the intention is usually that such slips eventually be expanded into full policy wordings (and English law provides that if and when that happens the full policy wording normally displaces the slip ab initio).[11] However, in many cases that was/is never actually done. In such cases the slip is and remains a binding contract once signed/subscribed.[12] Hence it is important that such "shorthand" is well understood in the market and it has frequently had to be interpreted by the Courts.

Foreign law and "back to back"

The general idea of facultative reinsurance contracts is usually that they should be "back to back", in other words that they should exactly parallel the underlying insurance so that the cedant may be relaxed in the knowledge that provided he meets the tests laid down in *ICA v Scor*, any payments he makes will be recoverable under his reinsurances. Questions inevitably arise, however, when the English market has reinsured a foreign insurance contract. Experience has shown that the same words and phrases used in contacts governed by different law can have different effects, with the result that the contracts are not "back to back" and the cedant/reinsured may not be paid.

Thus for example, in *Forsikringsaktieselskapet Vesta v Butcher*[13], the reinsurance was on the Lloyd's J1 form. This provides: "being reinsurance of and warranted at the same gross rate, terms and conditions as and to follow the settlements of the company". In that case the cedant Norwegian Insurance Company had insured a fish farm in Norway. The fish farm suffered serious storm damage. It was a condition of the insurance contract that "A 24 hour watch be kept over the site". No such 24 hour watch was kept but the existence of such 24 hour watch would not have affected the damage inflicted by the storm.

The insurance contract was governed by Norwegian law. Under Norwegian law, the fact that the 24 hour watch had not been kept, and that there was accordingly a breach of condition, was not a defence for insurers because the breach had nothing to do with the loss. Accordingly, the insured was able to succeed in a claim against the insurer.

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[11] Youell v Bland Welch (1990) 2 Lloyd's Rep 423, affirmed at (1992) 2 Lloyd's Rep 127. (In such a case, the slip is not even admissible as an aid to construction of the policy.) However, this is not an absolute rule and whether the policy supersedes the slip depends upon all the facts of the case and whether that is the agreed intent – see HIH Casualty and General Insurance v New Hampshire Insurance and Independent Insurance (2001) Lloyd's Rep IR 596.

[12] General Reinsurance Corporation v Forsakringsaktiebolagtet Fennia Patria (1983) 2 Lloyd's Rep 287.

[13] (1986) 2 Lloyd's Rep 179 QBD (Comm Court); (1988) 1 Lloyd's Rep 19 (Court of Appeal); (1989) AC 852 (House of Lords).

The J1 form, as stated, incorporated the same terms and conditions into the reinsurance policy. The reinsurance was almost entirely with Lloyd's underwriters. A reinsurance policy placed in London with Lloyd's underwriters or London companies is governed by English law as a result of the implied choice of the parties.[14] Under English law, a breach of warranty entitles an insurer (in this case reinsurer) to repudiate liability even if the breach is irrelevant to the loss suffered. Accordingly although (in fact, because) the wording of the policies was the same, the insurers were compelled to pay the insured but prima facie were not entitled to recover from their reinsurers.

The Judge in the Commercial Court, Hobhouse J, held that "As a matter of English law ... the proper law of the reinsurance contact is English law subject to the construction and effect of the clauses of the [brokers'] wording being determined in accordance with Norwegian law in the same manner as they are as part of the contract of original insurance".[15] In other words, as a matter of English law, the English law reinsurance must be interpreted to match properly the effect of Norwegian insurance, despite any normal English law to the contrary. So reinsurers had to pay.

This decision was unanimously upheld in the Court of Appeal.[16] It was also upheld in the House of Lords.[17] Although the speeches in the House of Lords were in differing terms, for present purposes the important quotation is probably from Lord Lowry, who said that "Like every Judge who has considered the case ... [he considered that] ... the real intention ... [of the parties was that the policy should be] ... "back to back" ... [and that] ... effect should, if legally possible, be given to it".[18]

A similar dispute was resolved by the Court of Appeal in *Groupama Navigation v Catatumbo CA Seguros*.[19] The insurance policy covered two vessels which were damaged. They had never been in class. There was a warranty of class in both the insurance and, separately, in the reinsurance. Further, the reinsurance, like the J1 slip, said that "All term clauses, conditions, warranties ... as original". Venezuelan law, like

[14] That a Lloyd's insurance policy is governed by English law as the result of the implied choice of the parties (in fact this applies to any London market policy - see Amin Rasheed Shipping Corp v Kuwait Insurance Co (1984) AC 50) has long been the law in England and is accepted internationally. For example, it is an example of such implied choice quoted in the Giuliano-Lagarde Report on the Rome Convention of 1980 governing the applicable law of contracts (1980) OJ C282/1. (The Rome Convention was incorporated into English law by the Contracts (Applicable Law) Act 1990. This applies only to contracts entered into after it came into effect and therefore did not apply to the 1977 contracts in Lexington v AGF.) The English Courts have repeatedly held this also to be the case in reinsurance contracts – eg Royal Exchange Assurance Corp v Sjoforsakrings AB Vega (1902) 2 KB 384 (pre Rome Convention) and Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd (1999) ILP, 729 (post Rome Convention).

[15] (1986) 2 Lloyd's Rep 179 at 194.

[16] (1988) 1 Lloyd's Rep 19.

[17] (1989) AC 852; (1989) 1 Lloyd's Rep 331 (HL).

[18] (1989) 1 Lloyd's Rep 331 at page 346.

[19] (2002) Lloyd's Rep IR 141.

Norwegian law, provides that a breach of warranty does not give insurers a defence unless it is material to the loss. English law, as explained above, does. Once again, therefore, the Court held that under English law the reinsurance was to be construed in line with the (Venezuelan law) effect of the underlying contract, so as to deprive reinsurers of their defence and ensure that the reinsurance responded.

The effect of *Vesta* and *Catatumbo* has been that London underwriters have understood for the last 20 years (but probably did not before about 1986) that where they write "back to back" facultative reinsurance, itself governed by English law but of a foreign law underlying insurance, the English Courts will interpret their reinsurance to match the effect of the underlying insurance.

Lexington v AGF – the facts

In this particular case, the original insured was Alcoa. Alcoa had been forced by the EPA to clean up a large number of sites which had been polluted by its aluminium smelting activities between 1942 and 1986. The costs were considerable: Alcoa looked to its insurers to pay them. In the end, it had to sue some 98 insurers on hundreds of policies in respect of a total of 58 sites, most within the United States but some outside it. Lexington was one of the insurers sued.

Lexington had insured Alcoa under an "all risks difference in conditions" property damage insurance policy. The policy was issued for the period from 1 July 1977 to 1 July 1980. There was no specific governing law in the policy. There was, however, a standard service of suit clause by which Lexington agreed to submit to proceedings in any State. Accordingly, Lexington, like all the other insurance companies, was joined into legal proceedings in the Courts of Washington State.

The case came before Judge Learned. On 10 June 1994, in a preliminary ruling, she held that the law of Pennsylvania should be applied to all the policies in issue in the proceedings, consistent with the approach of the American Law Institute's Restatement (2nd) on Conflict of Laws in respect of the choice of law in contracts.

In the event, the jury were unable to agree whether there was "a reasonable basis or bases on which to allocate to each separate policy year the costs relating to the property damage that occurred during that policy year. Accordingly Judge Learned had to rule on that issue. She ruled that there existed in law a reasonable basis for allocating to each separate policy year on a pro-rata straight line basis the costs relating to the property damage on each site.

On appeal, that ruling was emphatically disapproved by the Washington Supreme Court. The Washington Supreme Court applied the rule in JH France Refractories Co v All State Insurance Co, 534 Pa 29, 626 A. 2d 502 (1993), a decision of the Pennsylvania Supreme Court relating to asbestos disease. It ruled that: "It seems clear from the policy language that any physical loss or damage manifesting itself during the time a ... policy was in effect was covered by the policy, including pollution damage starting before the policy inception".

In other words, the Washington Supreme Court, applying Pennsylvania law, ruled that each and every insurer which had issued a policy which provided cover for a period in which any pollution damage manifested itself, no matter when that damage was actually caused including prior to the period of cover, was liable for the whole of the damage that manifested itself during that period. That ruling seems to have been a reasonable and proper understanding of Pennsylvania law, Pennsylvania being a State which has adopted the joint and several liability approach to such cases.

Faced with the ruling by the Washington Supreme Court, various insurance companies, including Lexington, negotiated with Alcoa. Lexington in particular negotiated a settlement of $103m in respect of the claims made against it.

Lexington's Reinsurance

Lexington's reinsurance policy in the London market (placed with a large number of companies) provided for cover for "36 months at date 1.7.77 [that is, in English notation, 1 July 1977] ... and/or pro rata to expiry of original." It was described as a "Contributing Facultative Reinsurance" and under "form" it was stated that it was "covering all risks of physical loss or damage excluding fire and allied perils &/or as original". Lexington's interest was in "all property of every kind and description and/or business interruption and OPP &/or as original". It included a "full R/I [reinsurance] clause."

The reinsurance policy did not contain an express choice of law clause. It was, however, placed in London, through a London broker, with English reinsurance companies (neither AGF nor Wasa were amongst the companies with whom reinsurance was placed: they are successors in title to such companies). Accordingly, there was no doubt that there was an implied choice of English law to govern the reinsurance contract (see footnote 14 above). Lexington never challenged this.

Lexington took the view that this reinsurance policy was "back to back" with its own insurance policy. In other words, if its own insurance policy had to respond, so should this reinsurance policy. It was for the same period (albeit slightly differently expressed) and indeed the expression "to expiry of original" expressly appeared in the period clause. It was expressed to be "&/or as original" in respect of the form, the interest, and where the risk was situated. It also had a full R/I clause, which meant that it should follow the settlements of the insurance policy (see footnote 9 above).

Lexington invoked the rule in *Vesta v Butcher* and *Groupama v Catatumbo.* Hence, Lexington said, even if Pennsylvania law interpreted Lexington's policy differently from English law, the English Court should force reinsurers to pay by interpreting, as matter of English law, the English law reinsurance policy in the same way.

AGF and Wasa argued that these rules only apply where there is an underlying system of law (which under English rules must be ascertainable at the time the contract is entered into - see below) by reference to which reinsurers could at the time they underwrote the reinsurance have worked out what they were letting themselves in for. In this case (said AGF and Wasa), the law of Lexington's policy was not ascertainable at the time the reinsurance was agreed. They further said that the choice of Pennsylvania law was in any event not an obvious one. Accordingly, reinsurers should not be held to the effects of a system of law they could not have foreseen.

Additionally they said that the "Vesta" and "Catatumbo" principle only applies if the claim is within the reinsurance – see the first test in *ICA v Scor*. In this particular case, they were being asked to cover loss and damage which had occurred outside, in particular before, their own policy period of 36 months from 1 July 1977. That they had intended to cover only loss and damage occurring within that period was clear on the face of the reinsurance policy; the period of cover is a fundamental matter not to be overridden by application of the Vesta principle.

The English litigation

At first instance in the Commercial Court, Mr Justice Simon agreed with AGF and Wasa.[20] He did so, broadly speaking, on both the main grounds advanced by AGF and Wasa.

[20] (2007) Lloyd's Rep IR 604.

The Court of Appeal allowed Lexington's appeal[21]. It (consisting of three Lord Justices) held unanimously that what the Washington Supreme Court had done was to interpret the Lexington policy and that this therefore fell squarely within the principle in Vesta and Catatumbo. Remarks were also ventured to the effect that the old distinction between reinsurance and liability insurance was outdated and artificial and that reinsurance contracts should be treated as if they were liability insurance contracts, thus rendering this sort of argument unnecessary.

The decision of the House of Lords

The Appellate Committees of the House of Lords used to consist of five "Law Lords" chosen by the Senior Law Lord as those best to hear the relevant case from a total number of twelve. [22] (It could be seven in unusual cases.) 30 July 2009 was the last date upon which the Appellate Committee of the House of Lords ever reported cases to the House of Lords and the House of Lords adjudicated cases. The House chose that day to rule on Lexington v AGF.[23]

(As a result of the Constitutional Reform Act 2005 the judicial functions of the House of Lords have now been taken over by a new United Kingdom Supreme Court, sitting for the first time on 1 October 2009. Under the transitional provisions of the Act, the Supreme Court (whose initial membership was the then Law Lords) adjudicated those cases which were heard by an Appellate Committee but on which the members had not by 30 July 2009 delivered their opinions to the House.[24])

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[21] (2008) Lloyd's Rep IR 510. An interesting feature of this case is that each lower tribunal refused permission to appeal, so in each case the appellant had to obtain that from the appellate tribunal – which then went on to allow the actual appeal unanimously.

[22] "Law Lords" (technically "Lords of Appeal in Ordinary") were Judges promoted from the Court of Appeal who were ennobled as Peers and sat in the House of Lords, which as "The Lords Spiritual and Temporal in the Court of Parliament of Her Majesty the Queen Assembled" was England's (indeed, the United Kingdom's) highest Court from 1399, when the House of Commons ceased its role in hearing petitions to reverse the decisions of the King's lower Courts. (The Lords Spiritual are Bishops of the Church of England, of whom 26 sit in the House of Lords.) By convention no other members of the House of Lords either attended the hearings of the Appellate Committee or spoke or voted at the sittings of the House of Lords to which the opinions of the members of the Appellate Committee were reported and at which the House then resolved to adopt them, thus adjudicating the case. (The membership of the Judicial Committee of the Privy Council, which is the final Appellate Court for those Commonwealth Countries and Dependent Territories who have not established their own such court, was virtually, but not entirely, the same as the Law Lords and will no doubt continue in the same relationship to the Supreme Court.)

[23] (2009) UKHL 40. For historic reasons – this was technically not an appeal but a petition to change a decision – the case remains as designated in the Court of Appeal; nevertheless Lexington was now the respondent and AGF the appellant (with Wasa).

[24] Judges elevated to the Supreme Court after its creation will not receive Peerages automatically, since they do not need to be members of the House of Lords. They hold the title of Lord Justice of the Supreme Court.

The Appellate Committee which considered Lexington v AGF was strong one. It consisted of Lord Phillips of Worth Matravers (the Senior Law Lord, now President of the Supreme Court), Lord Walker of Gestingthorpe, Lord Brown of Eaton under Heywood, Lord Mance and Lord Collins of Mapesbury.[25]

The Opinions (= Judgments) were strong and unanimous. Lord Phillips agreed with both Lords Mance and Collins, delivering a short opinion of his own. Lord Walker agreed with Lord Collins. Lord Brown agreed with Lord Collins but delivered a short opinion of his own. Lord Mance agreed with Lord Collins but delivered a lengthy opinion of his own and Lord Collins agreed with Lord Mance but delivered an opinion as long as Lord Mance's.

Broadly, their Lordships proceeded upon three foundations:

1. Lord Hoffman was correct in Charter Re v Fagan (see footnote 5) as to the nature of a contract of reinsurance. Both Lord Mance[26] and Lord Collins[27] expressly disapproved the comments in the Court of Appeal that the distinction between liability and insurance and reinsurance should be abolished.

2. A reinsurer cannot be held liable unless the loss falls within the risk assumed under the underlying insurance contract and the relevant risk has been properly assumed under the reinsurance contract.[28]

3. It is a fundamental concept of English property insurance law that: "the insurer is liable for a loss actually sustained from a period insured against during the continuance of the risk".[29]

There was precedent in England on the question of the allocation of losses from insurance to reinsurance contracts. In _*Municipal Mutual Insurance Limited v Sea Insurance Company Limited*_,[30] Municipal Mutual as insurer had paid as a single claim arising out of a single event damage arising from lack of supervision (which gave rise to pilfering "the huge bulk of which must in all probability have occurred between March 1987 and September 1988"[31]). However the event covered three separate years of reinsurance contracts, each with different excess layers. Waller J, the Judge at first instance, conceded that these policies "are different policies for different years [so] there is no room for ... applying some form of equitable

[25] Lord Collins was the only solicitor, as distinct from barrister, member of the Appellate Committee of the House of Lords (and so now is the only such Lord Justice of the Supreme Court).
[26] (2009) UKHL 40, paragraph 33.
[27] Ibid. paragraphs 113-115.
[28] Hill v Mercantile & General Reinsurance Co Plc (1996) 1 WLR 1239 HL.
[29] Knight v Faith (1850) 15 QB 649 at 667 per Lord Campbell CJ.
[30] (1998) Lloyd's Rep IR 421 (CA).
[31] (1996) LR LR 265 at 268, per Waller J.

apportioning as between years before establishing whether under and individual policy some liability arises"[32] but he then reached the pragmatic conclusion that all loss should be taken as arising in the single year in which the bulk of the pilfering occurred.

The Court of Appeal[33] did not agree. They allocated the loss pro-rata. Hobhouse LJ, giving the leading Judgment of the Court, said that: "In my judgment the Judge's approach to the question of construction was radically flawed ... The Judge 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 physical loss or 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. 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'."[34]

The conclusion reached by the Law Lords in Lexington v AGF was that Lexington's reinsurance was on a "losses occurring during" basis.[35] It followed that: "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, whenever caused or occurring, provided that part of such contamination manifested itself or was in being during the reinsurance period. That would involve reinsurers in an unpredictable exposure, to which their own protections would not necessarily respond. It would mean that the same exposure would arise, even if they had granted the reinsurance for a shorter period than the three year period matching the original, since the original itself would, even if in force for only one year, have had effectively the same exposure as that for which the Washington Supreme Court held it answerable. Under the approach taken by the Washington Supreme Court, reinsurers must have incurred liability (in practice probably up to the reinsurance limits), as soon as they wrote the reinsurance. The retention must likewise have been exhausted before the reinsurance period began, and cannot have fulfilled any object of

[32] (1996) LR LR 265, at 272.
[33] (1998) Lloyd's Rep IR 421 (CA).
[34] (1998) Lloyd's Rep IR 421 at 435-436.
[35] (2009) UKHL 40, paragraph 58(5).

introducing an element of discipline into insurers' handling of the insurance. These represent as fundamental and surprising changes in the ordinary understanding of reinsurance and of a reinsurance period as those to which Hobhouse LJ was referring in the Municipal Mutual case" (per Lord Mance).[36]

Lord Collins arrived at a similar view: "In the present case, however, there is no principled basis for treating the scope of the three 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" (998 P2d 856, at 883). If Lexington 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 Lexington, leaving Lexington to reinsurer the third year of cover elsewhere; or if the London market had elected to reinsure Lexington by way of three separate one year policies (as in Municipal Mutual Insurance Limited v Sea Insurance Co Limited ...). The periods of cover under the insurance and reinsurances would not be back to back. But Lexington would still be maintaining that, in the 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".[37]

Lord Brown was, if anything, even firmer on the subject. He said that " 'Physical loss or damage' under a policy providing cover for three years simply cannot be construed under English law to include pre-existing damage. The respective contracts are not, of course, back to back as to their governing laws. However powerful and far reaching the presumption that reinsurance is intended to respond to claims payable under the primary policy, it could not avail Lexington here unless English law were to regard it in effect as tantamount to a rule of law – unless, in short, English law were to dictate that reinsurance must always respond. English law does not, in my opinion, go so far. Vesta ... and Catamumbo ..., clearly the decisions closest in point, are authority for the presumption. They do not warrant its application in all the circumstances, certainly not so as to override so clear a temporal limitation as the reinsurance contracts stipulated here with regard to the risks covered."[38]

The House of Lords approached the application of the Vesta and Catatumbo principle in this case carefully. As Lord Collins said: "I would ... 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

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[36] Ibid. Paragraph 40.
[37] Ibid. paragraph 111.
[38] Ibid. paragraph 16.

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".[39]

Lord Mance too remained of the view, like the other Law Lords, that Vesta and Catatumbo remain good law. He referred to the principle set out in them expressly as "a sensible principle of construction".[40]

However, there were two reasons why Vesta and Catatumbo principle was not applicable in this case. Both were succinctly set out by Lord Phillips in his Judgment:

[1] "I agree with Lord Mance, for the reasons that he gives, that the 'full reinsurance' clause in this case, and 'follow the settlements' clauses in general, did not and do 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." [and]

[2] "Longmore LJ [who had delivered the leading Judgment in the Court of Appeal] concluded that at the time that the reinsurance was written those parties to it would have anticipated that the interpretation of the primary insurance would be determined according to the law of Pennsylvania and implicitly agreed that the same law would apply to the interpretation of the reinsurance. For the reasons given by Lord Mance and Lord Collins, I do not consider that this finding was justified."[41]

Taking those two findings in turn, the first is fundamental to the understanding of the English law of "back to back". It appears that the Vesta/Catatumbo principle will only be applied to terms and conditions within the cover, rather than to the terms which define the cover. In other words, fundamental matters such as time periods, nature of the cover written, the property covered and no doubt its location, will continue to be governed by the English law wording in the reinsurance contract, not by any foreign law of the underlying contract. So the first test in ICA v Scor must in principle be considered on the basis of the law of the reinsurance contract – English law if that is English law - excluding the Vesta principle.

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[39] Ibid. paragraph 116.
[40] Ibid. paragraph 51.
[41] Ibid. paragraphs 6&7.

This is not exclusively so. Lord Mance expressed the view that "In relation to the present contract ... the reinsurance period (expressed as a unitary period of 36 months at 1 July 1977) would be understood to run back to back with the insurance term of 36 months 'beginning and ending at noon standard time at location of property involved' ... similarly any doubt about the meaning of the sum reinsured of $20m in the aggregate in respect of Flood and Earthquake would be clarified by reference to the original, which makes clear that such aggregate applies to each of these perils separately. In each case, there is no doubt about the terms or effect of the original insurance wording and there would be no problem about making the necessary minor assimilation".[42] So minor "assimilations" under the Vesta principle to exclude "unmeritorious"[43] defences will still be made.

However, he went on to say that "It may not, perhaps, always be so easy to assimilate an original insurance and reinsurance, when one is concerned with as fundamental an aspect of a reinsurance as its definition of the risks and period insured and the period for which they are insured. ... [Counsel for Lexington] asked rhetorically : what more could Lexington have done to reinsure themselves on a fully back to back basis? ... Absent a common governing law, reinsurers may still sometimes be entitled to respond, with reference to the clear meaning that their contract has under the law governing it: what more could we as reinsurers have done to make clear the basis of reinsurance? A sensible principle of construction, established in Vesta and Catatumbo, cannot be made into an inflexible rule of law which would impose upon reinsurers a liability for which under the law applicable to the reinsurance, they did not bargain. The consideration that Lexington probably did not reckon on the liability which it was held to have in America is not by itself a conclusive reason for passing that liability to reinsurers who were, on the face of it, also entitled to be confident that no such liability could arise under the clear and basic terms of English law contract into which they entered."[44]

Lord Collins felt that the issues in Lexington v AGF "are more difficult and fundamental questions than those in Vesta v Butcher."[45] He considered that: "This is not a case about the interpretation of the policy period ...". [46] "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 in 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

[42] Ibid. paragraph 50.
[43] Ibid. paragraph 66 .
[44] Ibid. paragraph 51.
[45] Ibid. paragraph 56.
[46] Ibid. paragraph 109.

which the losses related. There is, in my Judgment, no principled basis for a conclusion in the latter sense".[47]

The ratio decidendi of the case in this respect is thus quite clear. Where there is an English law reinsurance with clear terms applicable to the scope of the risk, these will be enforced despite the Vesta principle. The Vesta principle may be used for "smoothing" small and unmeritorious points such as precise hour of the day to and from which a contract may take effect, or the interpretation of sub-limits within it, but not the major and fundamental parts in any significant way. The choice of English law (whether expressly or by implication) is enough to make clear what the English policy means and is to be taken as deliberate, and hence to prevent the reinsurance being "back to back" with the underlying policy if it is different. The parties could, after all, contractually have agreed the same law for both if they had wished.

The second point summarised by Lord Phillips relates to the floating law nature of the Lexington contract: "At English common law, the applicable law must exist and be identifiable at the time when the contract is made ... it is said to follow that it is not possible to specify a 'floating' applicable law (that is, a proper law chosen at a time later than the commencement of the contract)".[48] This seems also to be true under the Rome Convention.[49]

The suggestion made by the Court of Appeal was that it was foreseeable by the parties, at the time when reinsurance contract was agreed, that Pennsylvania law applied/would apply to the underlying insurance, despite the fact that no law was chosen in that contract. The House of Lords disagreed. Its view was that applying normal conflict of law principles, it was likely that if they had been able in 1977 to forecast what law would apply to the underlying insurance contract at all, the parties to the reinsurance contract would have expected it to be Massachusetts law. Further, the choice of Pennsylvania law made by Judge Learned (and endorsed in the Washington Supreme Court) was not made solely in respect of the Lexington insurance – it was made in respect of all the policies she had to construe.

No criticism was made by the House of Lords (or the parties) of Judge Learned's choice of such law. On the contrary, it was well understood that in doing so she had applied the principles laid down in the Restatement, and made a choice to be applied to hundreds of policies. Further, Judge Learned had made it clear not only that she regarded herself as determining that Pennsylvania law applied as a general rule, but

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[47] Ibid. paragraph 116.
[48] Fox Merrett & Smith, Private International Law of Reinsurance and Insurance (2006) paragraph 10.60, see eg Star Shipping AS v China National Foreign Trade Transportation Corp., "The Star Texas" (1993) 2 Lloyd's Rep 445.
[49] See Article 3(2), by necessary implication.

had also said that if specific or unique issues arose regarding one or more defendants or one or more sites, which raise significant considerations which overrode the general rule, they could be brought to the Court's attention. In other words, she at no time asserted that Pennsylvania law was necessarily the proper law she would have found to apply to the Lexington insurance had that been considered as a freestanding contract.

Accordingly, standing in the way of the application of the Vesta principle in Lexington v AGF was the fact that there was in fact no law governing Lexington insurance at the time when the reinsurance was agreed. (And that if there had been it would, according to the House of Lords in contrast to the Court of Appeal, have been Massachusetts law; interestingly Massachusetts law was applied to the Lexington policy in the Washington proceedings to strike down a limitation clause which would have precluded Alcoa's claim.)

"Lexington's case depends upon the application of a Pennsylvania legal dictionary. Lexington has not advanced its case on the basis that a Massachusetts legal dictionary could be relevant to or assist Lexington's position. In my view, the present case is materially different from both Vesta and Catatumbo. The reinsurance has a clear English law meaning. There was here no identifiable legal dictionary (formal or informal), still less a Pennsylvania legal dictionary, which can be derived from the interaction or operation of the terms of the insurance and reinsurance and which could lead to any different interpretation of the reinsurance wording. For reasons I have already given, the reinsurance is an independent contract, with its own terms which fall to be construed under English law, and I see no basis for interpreting it as covering any liability which might subsequently be held to arise under the insurance in any State whose law might ... be applied by reference to factors extraneous to the particular insurance to which alone the reinsurance related. It follows that there is no basis for construing the two contracts as back to back in the present situation." – per Lord Mance.[50]

Lord Collins agreed: "In my judgment, in complete contrast to Vesta v Butcher and Groupama v Catatumbo, in the present case there was in 1977, when the insurance contract and the reinsurance contract were concluded, 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".[51]

In summary, the existence of a "legal dictionary" for the underlying insurance from which reinsurers could have worked out what any relevant parts of their contract meant is fundamental to the application of the

[50] Ibid. paragraph 49
[51] Ibid. paragraph 108

Vesta principle and since by definition there was none in the circumstances, the Vesta principle could not apply. Even once Pennsylvania law was selected as applying to the Lexington policy, that selection was not made on the merits of the Lexington insurance policy itself but only as part of an overall case management decision. As a result, the English Court was not prepared to say that the Vesta principle attached to the choice of Pennsylvania law.

It must be remembered, of course, that the fact that the law of the "legal dictionary" turns out after the reinsurance is written to be different from what it was believed at the time to be does not enable reinsurers to avoid its application. That is just one of the risks they take (like the reinsured).

The decision of the House of Lords was based upon both of these considerations. Accordingly both will apply to future cases.

Whither?

If insurers want to be certain that in such circumstances their reinsurance will provide cover for whatever the Courts before which they may be taken rule to be the meaning of their policies, words such as "as original" and "follow the fortunes" and the existence of a full reinsurance clause will not alone always be sufficient to achieve this. It is now apparent that they apply only once the risk re-insured has been defined, as to time, risks and property covered. To avoid doubt, policies ought to include a clause in the reinsurance which specifies it is governed by the same law as the underlying insurance.

Even this may not be wholly satisfactory in terms. As indicated above American law may permit a "floating" law, that is to say one which is not ascertained until after the contract has incepted. English law does not permit that: it requires a system of law governing a contract to be ascertained at inception of the contract – see footnote 48 above. The "Star Texas" case is one where the contract provided for one party to be able to choose the applicable law, which was disapproved. So an insurance contract with a floating choice of law might not be helped by a clause which simply applies that to the reinsurance – it may be contrary to English law/public policy. A choice may need to be made at inception.

An alternative approach which might be successful is to agree English law for the reinsurance and to specify that all the clauses in it shall be interpreted so they are back to back with whatever the underlying insurance may be held to mean under whatever system of law a Court of competent jurisdiction may choose to apply to it. Lawyers will no doubt take some pleasure in working out appropriate wordings to achieve this effect. Even on this method, however, there may also be public policy implications since again the purpose of such wordings would be to negate a rule of English law bolstered by the Rome Convention.

Another way round the problem might be to use such wordings but to specify arbitration as the method of resolving disputes. Arbitrators have more latitude in how they may decide cases and the law which they may apply to do so.

There is also in theory no reason why underwriters should not (be asked to) write, if they wish, liability insurance covering cedants' insurance risks. In other words the market could adopt by contract the suggestion made in the Court of Appeal. The market already writes "stop-loss" cover which is de facto liability cover for members of Lloyd's syndicates design to put a limit on their exposure. There is no conceptual difficulty. The regulatory ramifications are considerable, however (as Lord Collins pointed out). Authorisation to write liability insurance will be necessary, and capital requirements are not the same as for reinsurance. Further since many contracts involve underwriters from many jurisdictions, despite the vaunted European "passport" (whereby an insurer authorised in one State in the European Union can underwrite in all the States) many checks on authorisation will be needed and the market may be small. New contract types would need to be developed in this age of "contract certainty", with all the litigation risks involved, so while this is a possible route, it may be practically difficult.

On the other hand, if reinsurers want to be sure that they get the fundamental period (and other things) that they intend, they would do well to specify English law (and probably jurisdiction) expressly. They must at least continue to ensure that their contracts are concluded in circumstances which make it certain that English law is applicable, even if some foreign Court were to rule upon the interpretation of, and the law governing, the contract.

However, obviously since such clauses have up to now not been thought to be necessary, there will be few existing reinsurance contracts which contain them. Either novation will be necessary or, no doubt more likely, there will be some further interesting litigation on this subject.

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