

Run-off update

April 2008

1) **Wasa v. Lexington: Has recovering from reinsurers become easier?**

Lexington insured an American company, Alcoa, under a policy which covered loss or damage to property. The policy period ran from noon 1 July 1977 to noon 1 July 1980. Lexington entered into a reinsurance contract with Wasa and AGF and the policy period was identical to that of the underlying direct policy. The reinsurance policy contained a clause which stated: "Being a reinsurance of and warranted same gross rate, terms and conditions as and to follow the settlements of the [reinsured]" and was governed by English law.

Environmental damage was sustained at Alcoa sites from 1942 until 1986 (and therefore damage was sustained during the policy period). Alcoa brought proceedings against Lexington in America and in 2002 the Washington Supreme Court held, as a matter of Pennsylvania law, (and as a result, arguably, of a false analogy with earlier US asbestos decisions) that the direct insurance policy was to be construed as rendering Lexington jointly and severally liable for the clean-up costs at the various sites, irrespective of whether the damage was sustained before, during or after the policy period. Lexington then settled with Alcoa and sought an indemnity from Wasa. Wasa sought a declaration that it was not liable and won at first instance, on the basis that as a matter of English law reinsurers could only be liable for the costs of remedying damage which occurred during the policy period (and not before or after).

The Court of Appeal has now overturned the judgment at first instance. The reinsured argued that the parties had known when they entered into the reinsurance that it was likely disputes would be decided according to the law of the state where the insured was based. The reinsurers argued that they had not contracted to indemnify the reinsured against any liability which it might incur under the insurance policy and instead had reinsured Lexington for a three year period (and not a fifty year period).

The Court of Appeal held that the parties here intended the definition of the policy period in both policies to have the same meaning (indeed, the same or equivalent wording should generally be given the same construction unless there are clear indications to the contrary). That definition (following the House of Lords case of *Vesta v Butcher* (1989) was governed by Pennsylvania law and it was sufficient that there is a way to ascertain the meaning of a term. In this case, any competent Pennsylvania lawyer could take a view as to the meaning of the period clause (or, failing that, a court could decide) and that was enough to render the meaning ascertainable. Also, reinsurers here had to take the risk that the local law might change (as it in fact did, and not in a way that could reasonably have been anticipated by either the reinsurers or the reinsured at the time they entered into the reinsurance policy) - the period clause meant the same in both contracts, whatever that meaning might be. This decision therefore went further than the *Vesta* case, since in that case the relevant term was clear and fixed at the date the reinsurance policy was concluded.



Longmore LJ indicated in his judgment that a way around this problem would be for reinsurers to use the Bermuda Form. He also acknowledged that it could be suggested that the meaning of the same words could be ascertained under English law where the reinsured was a captive local insurer.

The Court of Appeal's decision strikingly illustrates how far English courts will go to ensure that insurance and reinsurance operate "back to back", if they believe that that is what the parties originally intended. Reinsurers must take the risk that local law changes or the policy is given an unexpected interpretation long after the reinsurance is concluded. In this regard they will, in effect, be forced to "follow the fortunes" of their reinsureds, unless they contract out of that position.

Permission to appeal has been refused by the Court of Appeal and it is not yet known whether permission to appeal will be sought or obtained from the House of Lords.

2) FSA discussion on new arrangements for Part VII transfer

In our previous updates we have referred to the introduction of the FSA's report to the court setting out any significant issues in a Part VII transfer and the basis on which it does, or does not, object to a particular transfer. We referred to a roundtable discussion which the FSA planned to hold to discuss the form and function of its report and to obtain views as to how the new arrangement might be improved.

That discussion has taken place and we set out below some of the points discussed:

- It was felt that it would not be appropriate for the FSA report to include a reference to the commercial realities and purpose behind the scheme.
- Whether the FSA report would be needed in all cases and whether a test should be developed to determine when the FSA should produce a report.
- It was felt that the FSA should report on the issues which the FSA considers to be significant from a regulatory perspective.
- There was a general debate on how to encourage policyholders to raise objections as early as possible. Although the FSA's report is intended to assist the court, it might be possible to make it available to policyholders on the particular firm's' and/or FSA's website.

In addition to the roundtable discussion, the FSA produced a summary of the written responses that it had received. Various issues were raised, such as the suggestion that the process should be as flexible as possible (especially if the case was urgent and in the nature of a rescue). The main concerns were to avoid delays, an increase in professional costs and the duplication of material already before the court in evidence.

There were also concerns raised about how the FSA will take into account policyholder objections in the final version of its report.

It was also hoped that the independent expert and the FSA would continue to have a full dialogue and that there should be no need for the independent expert to address the FSA's report in his/her report. Further, it was felt that the expert's report ought to be the primary report and that although the FSA should refer to the expert's report where necessary, it should be cautious not to repeat or restate material in the expert's report.

Almost all respondents felt that drafts of the FSA's report should be made available as early on as possible to the applicant firm and the expert, but there were mixed views as to when the provisional report should be made available to policyholders and other affected persons.



Finally, there was almost universal rejection of the idea that court hearings should be adjourned for further consideration of objections in person.

3 Transfers of insurance business and former Names

In our previous updates we have referred to the consultation carried out by the Treasury on proposals to 1) make clear that a court sanctioning an insurance business transfer scheme can order that outwards reinsurance contracts transfer as part of the scheme; and 2) enable all former Lloyd's Names to transfer their outstanding insurance liabilities (and not just those Names who resigned from the Lloyd's market on or after 24 December 1996).

As we have previously advised, the consultation closed in January 2007.

We understand from the FSA that a change in legislation is expected imminently and we shall update you further once this legislation has been introduced.

4 Implementation of the Reinsurance Directive

We are currently compiling a summary of progress made by member states to implement the EU Reinsurance Directive and we anticipate that we will be in a position to circulate this by the summer.

5 Article for BILA

We have recently had an article on Part VII transfers published in the journal of the British Insurance Law Association (BILA). This article examined the various features of Part VII of FSMA, which distinguish the approach in the UK from other European states, the features which protect policyholders and looks at several decisions concerning the rights of parties to object to a transfer scheme. This article is now available to be viewed on our website:

<http://www.clydeco.com/knowledge/articles/part-vii-transfers-and-the-protection-of-policyholders.cfm>

Further information

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