

INSURANCE AND REINSURANCE

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Wasa v. Lexington: Buyer Beware

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In a much anticipated judgment, the House of Lords has found that reinsurers who subscribed to a facultative proportional cover are not invariably obliged to afford an indemnity. This ruling was reached notwithstanding an actual finding of liability by a court of competent jurisdiction that construed incorporated policy terms and conditions which obliged reinsurers to follow the reinsured's settlements.

Although the judgment proceeds on the basis that the normal commercial purpose of proportional facultative reinsurance is to afford cover on a "back to back" basis and that a presumption therefore arises that the terms of the direct and reinsurance policies should be construed consistently, it was held that there is no rule of law that requires a consistent outcome where the proper law of the two policies is not identical. Indeed, even where incorporated original terms are construed pursuant to the applicable law of the direct insurance, an English law reinsurance does not necessarily afford an indemnity in respect of "surprising" and "unanticipated" results that could not have been foreseen at the point of entering into the contract which are at odds with fundamental principles of English law.

Buyers of reinsurance will find this a surprising result that will require a re-assessment of the value of an English law reinsurance. Reinsurers may find that the decision will require changes in the way that business is written, although those in the run-off market will regard it as a welcome development. English litigation lawyers will certainly welcome the judgment and the opportunity it will present to identify other exceptions to the presumption of back to back cover which the House of Lords has held continues to apply in such situations.

History

Lexington's claim for indemnity from reinsurers arose from the set- / *continued page 2*

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¹ The authors represented Lexington throughout the proceedings.

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tlement of litigation brought by the Aluminium Company of America (Alcoa) against Lexington under an “all risks difference in conditions” (DIC) property damage insurance policy.

Between 1 July 1977 and 1 July 1980, Lexington was one of Alcoa’s property damage insurers. Lexington provided cover of US\$20,000,000 per occurrence and reinsured that risk on the

which Lexington provided insurance to Alcoa. This meant that the losses fell below the Lexington policy deductibles and that Alcoa could make no recovery.

Alcoa appealed and argued that, as a matter of Pennsylvania law, it could recover the full costs of remediation at any particular site provided that only *some* damage had occurred at the relevant site during the years when Lexington was at risk. The Supreme Court of Washington State (sitting en banc² as a

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London market on the same terms and conditions “as original” including, significantly, the insured period of 1 July 1977 to 1 July 1980. Wasa and AGF subscribed to a 2.5% line of the reinsurance by way of a one page slip policy.

Under the US Comprehensive Environmental Response, Compensation, and Liability Act 1980, Alcoa was required to remove waste caused by pollution over a period of decades and to restore sites from which that waste had been removed. Alcoa’s “costs of remediation” were substantial and it sought indemnity from its property damage insurers for reimbursement of those costs. Alcoa issued proceedings against Lexington and other insurers in the state of Washington, as it was entitled to do under the US Service of Suit clause.

At trial, it was established that pollution had caused property damage at several of Alcoa’s sites in the United States. The trial Judge determined to apply the law of Pennsylvania to the construction of the insurance contracts; the law of the State where Alcoa was incorporated and had its headquarters. Faced with 67 insurers and insurance contracts, she sought to find a “centre of gravity” for purposes of determining the applicable law.

Applying Pennsylvania law, the trial Judge found that the damage increased year by year in a more or less linear progression. It was, therefore, possible to divide the total costs of remediation by the number of years over which the pollution had occurred and to attribute specific remediation costs to the damage which occurred during the particular years during

court of nine judges) agreed with Alcoa and overturned the allocation ruling.

The Washington Supreme Court construed the terms of Lexington’s policy to have afforded very broad cover that extended to pre-inception damage. The Court specifically found that both the insuring clause and the policy definition of occurrence included “*no words of limitation*” whilst no relevant exclusion precluded cover for damage arising pre-inception. Plainly, the Washington Supreme Court decision came as a surprise to Lexington. However, faced with the judgment of Washington’s highest court, Lexington settled Alcoa’s claim of about US\$180 million for US\$103 million.

Lexington sought indemnity from Wasa and AGF who had taken a 2.5% line of the reinsurance³. Neither Wasa nor AGF argued that the settlement reached was anything other than proper or businesslike. Instead, the reinsurers argued that, properly construed, the claim by Lexington fell outside the scope of cover of the reinsurance. Specifically, it was argued that the English law contract had to be construed in accordance with a fundamental rule that a time policy⁴ could not afford cover for damage occurring either before or after the policy period.

Wasa sought a negative declaration from the High Court on the basis that it could only be liable for the costs of remedying

² All members of the Court participated.

³ In fact, their predecessor companies had subscribed for that line.

⁴ Also referred to as an “occurrence” or “losses occurring during” policy.

damage to property which *actually* occurred between 1 July 1977 and 1 July 1980. AGF later adopted Wasa's position and joined the proceedings. Simon J in the High Court agreed with the reinsurers, but a unanimous Court of Appeal reversed his decision. The House of Lords, however, agreed with the result reached by Simon J, and reversed the decision of the Court of Appeal.

The House of Lords' Judgment

In determining to allow the appeal by Wasa and AGF, Lord Mance accepted that the terms of the original policy were fully incorporated into the reinsurance and Lord Collins stressed that the "essence" of the bargain under a facultative proportional reinsurance is that the reinsurer takes a proportion of the premium in return for a share of the risk. Yet, by virtue of the fact that the Lexington and reinsurance policies were governed by different proper laws, they were not fully back to back and it was therefore open to reinsurers to rely on an English law construction of the incorporated terms to deny an indemnity to Lexington. In this way, what was said to be the clear commercial purpose in agreeing the reinsurance contract could be circumvented when faced with a liability that the parties could not have anticipated in 1977.

[2000] 2 Lloyd's Rep 350⁵. In both cases, it was considered that it would have been possible at the time of contracting to identify the applicable law of the original policy. However, in *Wasa*, Lord Collins concluded that in 1977 there was no identifiable system of law applicable to the insurance contract which could have provided a basis for construing the contract of reinsurance in a manner different from its ordinary meaning in the London Insurance Market. Lord Mance considered that the parties entering into the *Vesta* and *Catatumbo* reinsurances could have been taken to have had access to a "foreign legal dictionary" to interpret the language of the reinsurance.

Their Lordships specifically disagreed with Longmore LJ's conclusion in the Court of Appeal that an English court, had its own conflict of laws rules been applicable, would have concluded that the law of Pennsylvania applied to the construction of the insurance contract. Lord Mance, agreeing with Lord Collins, concluded that an English court would more likely have concluded that the laws of Massachusetts would have applied. However, Lord Collins made it clear that the ultimate question was not to be determined by reference to how an English court applying its own conflicts rules, would have determined the applicable law of the insurance

Reinsurance is an independent contract which does not reinsure the liability of the reinsured but rather is a further contract on the subject matter originally insured.

The House of Lords confirmed that reinsurance is an independent contract which does not reinsure the liability of the reinsured but rather is a further contract on the subject matter originally insured. Lord Mance confirmed the proposition that independent terms of the reinsurance had to be satisfied before insurers could establish the right to indemnity. In their Lordship's view, the scope of indemnity afforded by the reinsurance was necessarily a matter of construction in each case.

Both Lord Mance and Lord Collins distinguished the two most directly relevant cases relied upon by Lexington, *Forsikringsaktieselskapet Vesta v Butcher* [1989] A.C. 852 and *Groupama Navigation et Transports v Catatumbo C.A. Seguros*

contract. He observed that the "issue is one of construction of the reinsurance contract."⁶

There was no doubt that the construction arrived at by the Washington Supreme Court was wholly different from that which any English court would have / continued page 4

⁵ In both of these cases it was held that a clause (a warranty) in a facultative reinsurance which was in the same or similar terms to a clause in the original insurance, should be given the same effect, notwithstanding that the two contracts were governed by different laws - the reinsurance by English law; the original insurance by Norwegian law in *Vesta* and Venezuelan law in *Catatumbo*.

⁶ [2009] UKHL 40, at paragraph 94

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reached; it being clear as a matter of English property insurance law that “the insurer is liable for a loss actually sustained from a peril insured against during the continuance of the risk.”⁷

Analysis

Reinsurers and reinsureds alike will note the significance of the uncertainty created by the House of Lords’ decision. A slip

The focus on reinsurers’ assumptions at the time of entering into the contract is surprising given the absence of any express term or language in the reinsurance that would indicate an intention to accept only part of the risk reinsured. The absence of such a distinction was considered important by Lord Templeman in *Vesta* when he concluded that the construction of the warranty in the original policy should bind reinsurers.

Perhaps the emphasis on reinsurers’ assumptions reflects a new found appreciation for the attention paid to the legal sig-

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policy which used virtually identical language produced an inharmonious result in contrast to those reached in *Vesta* and *Catatumbo* notwithstanding the fact that those cases also involved construction of a reinsurance policy governed by English law as a matter of implication.

In *Wasa*, it is difficult to discern anything other than an objective intention of both Lexington and its reinsurers to accept their proportionate share of an adverse judgment against Lexington. Yet, the absence of the clearly identified proper law in the original contract has apparently entitled reinsurers to escape indemnity based exclusively on what they were entitled to have assumed when entering into the reinsurance. Lord Mance observed:

“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 the English law contract into which they entered.”⁸

nificance of language used by market practitioners. Lord Mance observed that reinsurance business was conducted worldwide by experts “possessing very considerable legal knowledge and expertise”⁹. This is to be contrasted with the view he expressed in *Catatumbo* where he wrote:

“Yet it is to be said that the two contracts are not back to back, not because of any significant difference in the wording, but because they are subject to different laws, which attach to them different significance. To a lawyer, it may be that words only acquire significance in the context of a particular legal system. But I doubt whether that would be the first thought of insurance market practitioners when considering whether these two contracts were in terms back to back.”¹⁰

In light of the fact that the reinsurance in *Wasa* was written in 1977, it might be thought that the reference to market practice in *Catatumbo*, a year 2000 judgment, might be more apt to apply than the description quoted above. In fairness, the contrast in the characterisation of the legal awareness of mar-

⁷ At paragraph 74, citing *Knight v Faith* (1850) 15 QB 649, at 667

⁸ [2009] UKHL 40, at paragraph 51

⁹ [2009] UKHL 40, at paragraph 33

¹⁰ [2000] 2 Lloyd’s Rep 350, 355

ket participants might not have been critical to the legal analysis relied upon in reaching the decision to allow the appeal. Nevertheless, it may assist in understanding the approach to the issues presented.

It is also instructive to note that Lord Collins' speech begins with a reference to the significance of reinsurance as an invisible export of the United Kingdom. No party had raised this point in written submissions or oral argument at any stage of the proceedings. It is unclear what significance this point had to a determination of the issues presented.

It is apparent that the Law Lords were conscious that the decision in *Wasa* might create significant uncertainty. Thus, Lord Brown stressed "the comparatively narrow basis" on which he believed the appeal should succeed, whilst Lord Collins, with whom a majority of the House agreed, wrote that "this was an unusual case" which served to displace the pre-

ance, which means that the reinsurer agrees that if the insurer is liable under the policy the reinsurer will accept liability to pay whatever percentage of the claim he has agreed to reinsure. A reinsurer could, of course, make a special contract with an insurer and agree only to reinsure some of the risks covered by the policy of insurance, leaving the insurer to bear the full cost of the other risks. Such a contract would I believe be wholly exceptional, a departure from the normal understanding of the back to back nature of reinsurance and would require to be spelt out in clear terms. I doubt if there is any market for such a reinsurance".¹²

The result in *Wasa* is likely to test Lord Griffiths' view of market reactions. Certainly, the payment of premium in return for

If the back to back presumption is no longer intact, will reinsureds be quite so willing to come to London in the future to purchase their reinsurance when other markets are readily available?

sumption that liability under a facultative proportional reinsurance should be coextensive with that of the insurance. Indeed, Lord Collins seemed at pains to reiterate that:

"[i]t would almost invariably be the case that losses for which the insurer has indemnified the original insured would be within the reinsurance even if the losses are payable under a foreign law or a foreign judicial decision which takes a different view from English law of what losses are recoverable".¹¹

Lord Collins also specifically referred with approval to the oft cited speech of Lord Griffiths in *Vesta* in which he said:

"In the ordinary course of business reinsurance is referred to as back to back with the insur-

a policy that "almost invariably" affords indemnity is unlikely to be satisfactory to most reinsureds.

Both the Court of Appeal and the House of Lords approached this matter as an exercise of construction. The House of Lords seemingly attached greater significance to the expectations of reinsurers in light of what they apparently regarded as an unwarranted extension of cover by the Washington Supreme Court. Many market practitioners believe that the approach taken by the Court of Appeal, namely a determination of what was actually agreed in 1977 by reference to the brief terms of the reinsurance, more accurately reflects that agreement.

The Court of Appeal accepted that the parties to the 1977 contract intended that the fully incorporated terms of the original should have the same meaning in the reinsurance. The use of hindsight by the House of Lords to analyse whether any particular outcome had been / continued page 6

¹¹ [2009] UKHL 40, at paragraph 116

¹² [1989] AC 852, 895B-D

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within the agreed scope of indemnity to be afforded under the reinsurance has created real uncertainty about what other principles of English law might displace the presumption of back to back cover. If the back to back presumption is no longer intact, will reinsureds be quite so willing to come to London in the future to purchase their reinsurance when other markets are readily available?

The Way Forward

Naturally, any judgment which produces a result that is at odds with the agreed commercial purpose of the contract at issue requires parties in a similar position to reassess the basis on which facultative proportional reinsurance can be agreed. It is respectfully submitted that the judgment in *Wasa* will make it hard for non UK insurers to accept English law as the proper law of any similar reinsurance. It is unlikely that non UK reinsureds will willingly participate in a litigation lottery to ascertain what exceptions may exist to the presumption of back to back cover.

The House of Lords has found that where the original policy contains only a service of suit clause and does not identify the proper law of the contract, the relevant question is what the parties would have contemplated at the time of contracting as being regarded (according to US conflicts principles) as the relevant governing law of the insurance contract. Clearly where a service of suit clause is used, it will not be apparent in advance what state's conflicts rules will be applied. Moreover, the determination as to proper law by the US court chosen by an insured might depend on factors arising from the nature of the litigation, as in fact occurred in the *Wasa* case. It must be apparent that the exercise being contemplated is one involving many difficulties.

Further, a clear identification of the law applicable to the insurance would not necessarily cure the problem. Lord Mance specifically contemplated that the identification of the governing law in the insurance “*would not necessarily foreclose all argument. 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...*”.¹³ Thus, it appears that even if the Lexington policy had been expressly governed by Pennsylvania law, the result in *Wasa* would have been the same because the joint and several liability principle was adopted by that State only in 1982 and would

therefore have been unanticipated at the time that the reinsurance contract was entered into.¹⁴ It would in any event have been fundamentally at odds with the answer that any English Court might give.

Bearing these factors in mind, one obvious answer may be to require that the reinsurance be subject to the same proper law as the insurance. One can readily imagine that, in most instances, this will mean that insurers will seek to displace English law as the proper law of the reinsurance. Whether this is acceptable is, of course, a matter to be resolved through negotiation in the market.

Another approach might be for reinsurance to include a term making it clear that it will respond to claims no matter how the proper law of the insurance is applied by a court of competent jurisdiction, regardless of whether the result reached differs from that of an English court. Indeed such a clause would likely have to explicitly require reinsurers to afford an indemnity even if the result obtained were different to that which it might have been assumed would be obtained at the time of contracting.

There are several hints in the speech of Lord Collins (with whom the majority agreed) that in reality, reinsurance is indeed “*liability insurance which provides cover for the reinsured in the event that the reinsured is liable to pay the original insured*”¹⁵. Lord Phillips, though maintaining the traditional view that reinsurance is not a liability insurance, suggested that the analysis had much to commend it and considered that it was an approach that: “*it would be open to the market, by appropriate contractual terms, to follow*”¹⁶. In light of the success of the appeal in *Wasa*, clear language can and should be adopted to restore the true commercial purpose of facultative proportional reinsurance. An implied choice of law ought not to become an unwritten escape clause that allows an adverse outcome at the insurance level to be avoided at the reinsurance level. ☺

¹³ [2009] UKHL 40, at paragraph 51

¹⁴ *J H France Refractories Soc v Allstate Insurance Co* 534 Pa 29 (1993) citing *Keene Corp v Insurance Company of North America* 667 F.2d 1034

¹⁵ [2009] UKHL 40, at paragraph 114

¹⁶ [2009] UKHL 40, at paragraph 8

Can a Claim Payment be a Voidable Preference in an Insurance Company Liquidation in the United States? No Says the Pennsylvania Supreme Court

by Donald J. Mros, Washington, DC, dmros@chadbourne.com

An innocent policyholder may not realize that a claim payment it receives on its policy may be subject to a preference claim should its insurer be placed into an insurance company receivership even if the insured had no knowledge of the insurer's perilous financial condition when the payment was made.

Whenever a policyholder receives a payment from a financially troubled insurer, the policyholder may be faced with a later voidable preference challenge from the liquidator of the insurer (or rehabilitator in a few states) should the company be placed into liquidation or rehabilitation.¹ This could result in the insured having to return the payment, and then be left with just a claim on its policy that will almost certainly result in a diminished recovery far in the future. Almost every state in the United States has statutory provisions that authorize an insurance company receiver to avoid a preferential transfer and recover the payment under certain circumstances.² Recently, however, the Pennsylvania Supreme Court found that a claim payment on an insurance policy was not a voidable

preference even though made in the preference period. *Ario. v. Ingram Micro, Inc.*, 965 A.2d 1194 (Pa. 2009).³

A preference is defined generally as a transfer of money or property whereby a creditor receives more on its debt than similarly situated creditors during some specified period (usually one year) prior to a successful petition for the liquidation or rehabilitation. Many states, including Pennsylvania, also require that the transfer be on account of an "antecedent debt" for it to constitute a preference. Although this is an important term, it is not defined in any of the state insurance rehabilitation and liquidation acts that include the antecedent debt requirement.

Even if the transfer is a preference, it can only be avoided by the receiver and the payment recovered from the creditor in certain circumstances. The majority of states including Pennsylvania have enacted a provision that allows for the avoidance of a preferential transfer in any of the following circumstances: (1) the transfer was within four months of a successful liquidation petition; (2) the transfer was within one year of the successful liquidation petition and the insurer was insolvent at the time of the transaction; or (3) the transfer was within one year of a successful liquidation petition and the creditor receiving the payment had "reasonable cause to believe at the time the transfer was made that the insurer was insolvent or about to become insolvent." See *e.g.* 40 Pa. Cons. Stat. § 221.30.⁴ The first two circumstances allow for avoidance even if the creditor had no intent to do better than other creditors or even had any knowledge of its insurer's precarious financial situation. The *Ario* decision would give some comfort to these innocent creditors although the decision is limited to Pennsylvania.⁵

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¹ Eight states authorize a rehabilitator to seek to avoid preferential payments. Ala. Code § 27-32-27; Ark. Code Ann. § 23-68-125; Del. Code Ann. tit. 18, § 5925; Md. Code Ann., Ins. § 9-221; Nev. Rev. Stat. § 696B.410; N.J. Rev. Stat. § 17:30C-25; N.Y. Ins. Law § 7425; Or. Rev. Stat. § 734.350; Va. Code Ann. § 38.2-1513; Wyo. Stat. Ann. § 26-28-124. For convenience in this article, we will refer to an insurance company liquidator or rehabilitator as a receiver.

² Three states do not have statutory preference provisions. See Mass. Gen. Laws Ann. ch. 175, §§ 6, 180A-180L; Okla. Stat. tit. 36, § 1901-1920; Wash. Rev. Code. § 48.99.

³ Insurance companies in the United States are not subject to the United States Bankruptcy Code. 11 U.S.C. § 109(b) (insurance companies are excluded from being debtors). The rehabilitation or liquidation of an insurance company is subject to the state insurance law of the domicile of the insurance company. State law varies on preference requirements as well as other matters related to insurance company receiverships.

⁴ Insider dealings or non-arms length transactions may also be avoided as preferential. See, *e.g.*, 40 Pa. Cons. Stat. § 221.30(a)(iv).

⁵ A minority of states have a different provision which includes intent and knowledge elements. The New York provision is an example: "[a]ny transfer of, or lien created upon, the property of an insurer within twelve months prior to the granting of an order to show cause under this article with the intent of giving the creditor or enabling [it] to obtain a greater percentage of [its] debt than any other creditor of the same class and which is accepted by such creditor having reasonable cause to believe that such a preference will occur, shall be voidable." N.Y. Ins. Law § 7425(a). Generally, the minority provision does not include the element that the transfer be on account of an antecedent debt.

Claim Payments

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Pennsylvania Supreme Court Recognizes Ordinary Course of Business Exception To Preference In *Ario v. Ingram Micro, Inc.*

Ario involved the liquidation of the Pennsylvania company, Reliance Insurance Company (“Reliance”). *Ario*, 965 A.2d at 1196-1207. Several policyholders of Reliance had received claims payments on their trade credit insurance policies within one year of the successful liquidation petition for Reliance. The Reliance liquidator sued to recover the payments on the grounds that they were preferential payments made within the one year preference period. The policyholders contended that they were not preferences because they were not on account of an antecedent debt. On other grounds, the lower court held they were not preferences and the Liquidator appealed to Pennsylvania’s highest court.

The Pennsylvania Supreme Court agreed with the policyholders that the insurance payments were not on account of an antecedent debt as they were made in the ordinary course of business. *Id.* at 1207. The Court reached this decision although there is no explicit exception in Pennsylvania’s pref-

ferred differing reasonable interpretations of its meaning. *Id.* at 1202. The Court then turned to divining the intent of the legislature regarding the meaning of the term.

It first determined that the intent of the Pennsylvania rehabilitation and liquidation act was to protect policyholders, other creditors and the general public. It then considered federal bankruptcy law on preferences, which the Court said may be relied upon to interpret state insurance receivership statutes because bankruptcy law is a basis of the state laws. Bankruptcy law contains an exception to preferences for ordinary course of business payments. The Court further considered the general purposes of the preference laws and the requirement of an antecedent debt, which is to prevent out of the ordinary payments by a troubled insurer which would hasten its slide into receivership to the disadvantage of creditors who were not the beneficiaries of such payments. It also considered the consequences of a finding that insurance payments could be voidable preferences and decided that it could disrupt Pennsylvania’s large insurance market. Policyholders may be inclined to purchase policies from companies not domiciled in Pennsylvania if they were faced with the threat that an insurance payment could be recovered by an insurance

The reasoning of the Pennsylvania Supreme Court is instructive as it may be a conclusion reached in other states that have similar voidable preference provisions as Pennsylvania’s.

erence statute for payments made in the ordinary course of business. The reasoning of the Pennsylvania Supreme Court is instructive as it may be a conclusion reached in other states that have similar voidable preference provisions as Pennsylvania’s.

The Pennsylvania Supreme Court first noted that the term “antecedent debt” is not defined in Pennsylvania’s preference statute and that in interpreting legislation the Court’s function is to ascertain and effectuate the intent of the legislature. Where the words are clear, they should be enforced. Here, the Court found the term “antecedent debt” to be ambiguous as the legislature had not defined the term and the parties had

receiver of that company and therefore put Pennsylvania at a competitive disadvantage with other states. It also looked at the couple of other decisions on the issue in other states which are discussed below. *Id.* at 1203-1205.

Considering these various facts, the Pennsylvania Court concluded that the legislature intended the term “antecedent debt” not to include transfers made in the ordinary course of business. The Court found that its interpretation upheld the economic expectations of the public and the interests of insurers and at the same time protected against unusual transfers. *Id.* at 1205.

The *Ario* decision is only one of three Court decisions in the

United States on the issue of whether ordinary course of payments are preferential under the state insurance laws where there is no explicit exception in the state statute. A similar decision was reached by an Ohio appellate court, but it did not involve an insurance claim payment. The Ohio Court held

period from an insurer domiciled in Pennsylvania, Utah, Texas, Illinois or Ohio, it could argue ordinary course of business payment in the face of a preference claim from a receiver. Nebraska, though, does not recognize the exception. For the rest of the jurisdictions in the United States, our insured would

The Ario decision is only one of three Court decisions in the United States on the issue of whether ordinary course of payments are preferential under the state insurance laws where there is no explicit exception in the state statute.

that payments for printing and mail services by an insolvent insurer prior to its liquidation during the preference period were in the ordinary course of business and therefore not on account of an antecedent debt. *Covington v. HKM Direct Market Commc'ns, Inc.*, 2003 Ohio 6306 (Ct. App. 2003). Ohio at the time had a similar preference statute as Pennsylvania which did not contain a definition of “antecedent debt” or an exception for ordinary course of business payments.⁶ An opposite conclusion, though, was reached by the Nebraska Supreme Court on payments to an obligee on a performance bond under the same preference statute as enacted in Pennsylvania. The Nebraska Court concluded that the surety’s payments were made during the preference period and refused to read into the state statute an exception for ordinary course payments since the legislature did not specifically include one in the Nebraska statute. *Wagner v. Gilbane Building Co*, 757 N.W.2d 194 (Neb. 2008). Finally, four states currently have explicit statutory exceptions to a preference claim for ordinary course of business payments.⁷

Conclusion

To conclude, let us look at our innocent insured who has no idea that its insurer is about to fall into the abyss of liquidation. If the insured received a payment during the preference

have no clear answer because the state insurance laws do not address the situation. ☹

Material Change of Risk; Keep an Eye on the Sprinkler System!

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Changes of risk termination provisions have traditionally been given a narrow construction by the English courts. However, in *Quayyum Ansari v New India Assurance Ltd* [2009] EWCA Civ 93, the Court of Appeal has ruled that an increase in risk can become a material change of risk and thereby discharge the insurer from liability.

Background

In May 2004 Mr. Quayyum Ansari approached New India Assurance Ltd (“New India”) seeking insurance cover for his factory. The premises was let to his friend, Mr Ali Asim, who used the factory for his wholesale kitchenware business. / continued page 9

⁶ Subsequent to the *Covington* decision, Ohio revised its preference statute to include an ordinary course of business exception. Ohio Rev. Code Ann. § 3903.28(A)(4)(a).

⁷ 215 Ill. Comp. Stat. Ann. § 5/204(m)(A); Texas Ins. Code Ann. § 4443.204(c)(1)(A); Utah Code Ann. § 31A-27-321; and Ohio in 2004, Ohio Rev. Code Ann. § 3903.28(A)(4)(a).

Material Change of Risk

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During the application process Mr. Ansari completed and signed a proposal form which asked “Are the premises protected by an automatic sprinkler system?” He answered “Yes”, but, despite being asked to do so, did not give any details of the system in use. He also described the business carried on at the premises as “Tenants (wholesale kitchenware)”. In signing the proposal, Mr. Ansari declared that the statements contained in it were true to the best of his knowledge and belief.

First, Mr Justice Patten was satisfied on the evidence that Mr Ansari had been aware prior to the fire that the sprinkler system had been turned off. Mr Ansari had visited the factory on a number of occasions, which would have made him aware that the system had been disabled. On this basis, he could not rely on the non-invalidating clause in the policy.

Secondly, the Judge considered whether there had been any “material” alteration to the factory or any “material” change to the answers provided in the proposal form as per the general condition of the policy. In making his decision,

It was held that a material alteration or change in this context is one which “significantly affects the risk” and as a result took the risk outside that which was in the “reasonable contemplation of the parties at the time the policy was issued”.

New India subsequently issued Mr Ansari an insurance policy on its standard terms. This case concerned one section of the policy; cover against destruction of or damage to the building, including fire.

The policy contained the following general condition:

“This insurance shall cease to be in force if there is any material alteration to the Premises or Business or **any material change in the facts stated in the Proposal Form** or other facts supplied to the Insurer unless the Insurer agrees in writing to continue the insurance.”

A fire broke out in the factory causing considerable damage to both the building and contents. However, the tenant had deactivated the sprinkler system during the policy period by isolating it from the mains water supply. To make matters worse, the water supply had been cut off because the tenant had failed to pay the water bills. Further, the factory contained a considerable quantity of goods which were not kitchenware, including small petrol powered motorbikes. New India rejected the claim and cancelled the policy.

First Instance Decision

Mr Justice Patten had little sympathy with the insured’s predicament:

the Judge was invited to consider two authorities: *Pan Atlantic Insurance Co. Ltd v. Pine Top Insurance Co. Ltd* [1995] 1 A.C. 501; and *Kausar v. Eagle Star Insurance Co. Ltd* [2001] Lloyd’s Rep. IR 154. In *Pan Atlantic* the House of Lords held that an insurer who seeks to avoid the contract on grounds of misrepresentation or non-disclosure must also establish that it induced him to accept the risk on terms to which he would not otherwise have agreed. Whereas in *Kausar* the Court of Appeal held that an insurer could not rely on a term requiring the insured to notify of circumstances which increase the risks (save in the most extreme circumstances) in order to avoid liability.

Mr Justice Patten held that a properly functioning sprinkler system was something that was of concern to New India and that was why the specific question appeared in the proposal form. New India argued that the expressions “material alteration” and “material change” should be construed in accordance with *Pan Atlantic*. On the other hand, Mr Ansari argued that the clause should be construed in the same way as the clause in *Kausar*. However, Patten J distinguished *Kausar*, drawing a distinction between (i) provisions focusing on changes of circumstances which increased the risk of damage (as in *Kausar*); and (ii) conditions such as the General Condition which operated on a **material change** in the facts stated in the proposal form. Patten J held that disabling the

sprinkler system to the extent that it was unlikely to work was more than an increase in the risk and had amounted to a material change.

The Court of Appeal

Mr. Ansari appealed the decision. The Court of Appeal considered four key issues:

1. What relevant facts were contained in the proposal form?
2. Was there a subsequent change in any of those facts?
3. If there was, was the change material?
4. If it was material, did Mr. Ansari know of the change?

The Court of Appeal found that by stating in the proposal form that there was a sprinkler system in the factory, Mr Ansari was effectively informing the underwriter that there was a system in place that *“forms an integral part of the building and moreover is one which (unlike an intruder alarm) is intended to function permanently, in the sense of being constantly ready to operate in the event of a fire without the need for human intervention”*.

Further, Mr Asim had deliberately disabled the sprinkler system and that because he had not paid the water bills (resulting in the water supply being cut off) it was clear that Mr Asim deemed the system dispensable. Moore-Bick L.J. contrasted this with a scenario where the system was only temporarily switched off, for example for maintenance or repairs, which would not mean that the factory was no longer protected by a functioning system.

The Court of Appeal was equally satisfied that on the facts Mr Asim had been using the factory to trade items other than kitchenware goods.

However, the key to the case was whether any of these changes were material within the meaning of the general condition. In reaching its decision, the Court of Appeal concluded that the word “material” in the clause was used in a similar context to the condition in *Kausar*. The Court of Appeal thought that Mr Justice Patten was therefore wrong to construe the word “material” in accordance with *Pan Atlantic*, as this case considered the test for “material” in the context of negotiations **leading up to** the formation of a contract. Had the Court accepted the test in *Pan Atlantic*, it would have left the insured in a precarious position where, at any point during the policy period, the policy would *“automatically lapse on the occurrence of any new circumstances which would influence to any extent the judgment of a prudent insurer in deciding on what terms he would be prepared to accept the risk.”*

By aligning the condition more closely to the principle in *Kausar*, it was held that a **material** alteration or change in this context is one which *“significantly affects the risk”* and as a result took the risk outside that which was in the *“reasonable contemplation of the parties at the time the policy was issued”*. Moore Bick LJ stated that New India underwrote the insurance having specifically asked about a functioning sprinkler system and a permanently disabled sprinkler system is a material alteration in the nature of the subject matter of the insurance. It is for the insured to inform the insurer of this change and ask if the insurer wishes to continue to provide insurance; failure to do so means that the insurance ceases to be in force.

The Court of Appeal agreed with Patten J that because Mr. Ansari knew that the sprinkler system was permanently disabled, he must have understood that the statement in the proposal form no longer applied. The knowledge meant that Mr Ansari could not rely on the non-invalidity provision and his claim must fail.

Comment

What is the potential impact of this decision? Prior to the Court of Appeal’s decision, the traditional common law approach was that a material change would relate more to a complete change of use of the insured’s factory rather than a change in the **subject matter** of the insured risk.

The ruling means that going forward the insured will need to pay more attention to the questions raised in proposal forms on the basis that these questions highlight those areas of the insured risk that are of concern to underwriters. It also means that the insured will need to consider whether any particular changes in the subject matter of the insurance during the policy period may affect cover.

Whilst this case provides a useful insight of what may be deemed a material change during the policy period, any analysis is naturally fact specific. The ruling is therefore unlikely to be the last decision on this matter. In the meantime, it is important for the insured to give plenty of thought to any ongoing disclosure obligations. If in doubt, the insured should notify underwriters as soon as possible of any changes — preferably before any changes have been implemented. The underwriter can then decide whether he wants to continue to provide cover. ☺

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Chadbourne Counsel Don J. Mros was part of a panel discussion on setoff issues and presented on, "Setoff Issues – The U.S. Legal Perspective." For a copy of the PowerPoint presentation, please visit http://www.chadbourne.com/files/upload/AIRROCo9-DonMros_PP_Slides.pdf.

We would like to thank all of those who came along to the Chadbourne & Parke booth at this year's AIRROC/Cavell Rendez-Vous. We hope that the Rendez-Vous was a success and we look forward to meeting with you all again soon. For a copy of the materials distributed at this year's booth, please visit http://www.chadbourne.com/files/upload/AIRROCo9-CP_Insurance_Practice.pdf.

Please let Don Mros know if you have any questions after reviewing the PowerPoint presentation and materials. Don can be contacted at: dmros@chadbourne.com

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