A Defining Moment for the London Market?

An Analysis of the Judgment in:
David George King and Others v Brandywine Reinsurance (UK) Ltd
(formerly Cigna Re Co (UK)

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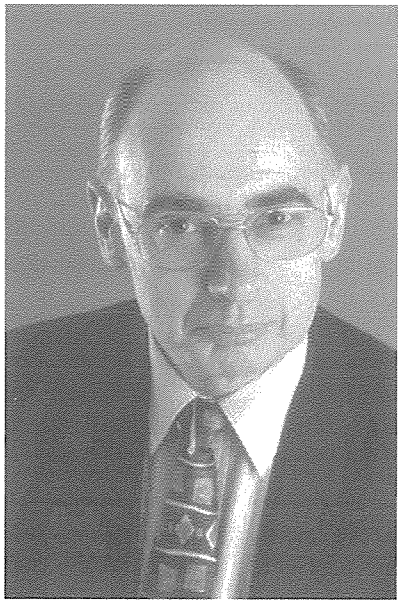

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with acknowledgments*

On May 10 2004, Mr. Justice Colman, sitting in the Commercial Court in London, gave judgment in this case involving claims by reinsurers in the London Market to be indemnified by their retrocessionaires in respect of payments made by reinsurers for claims arising out of the Exxon Valdez oil spill in Alaskan waters in March 1989.

This lengthy judgment of Mr Justice Coleman may help to clear the logjam of excess of loss claims arising from the *Exxon Valdez* disaster. The judge found the defendant retrocessionaires were not liable under their Excess of Loss reinsurance contracts to indemnify the reinsured in respect of settlements reached with the underlying insured, Exxon.

[To avoid confusion, this paper on occasion refers to the claimant reinsurers as "insurers", the defendant retrocessionaires as "reinsurers" and to the retrocession policy as the "reinsurance"]

Background
On 24 March 1989, the *Exxon Valdez* ran aground in Prince William Sound off the coast of Alaska, causing a spill of 258,000 barrels of crude oil. The cargo was owned by Exxon Corporation, the vessel by a subsidiary, Exxon Shipping Corporation ("ESC"). There followed a massive containment and clean-up operation carried out by ESC until it was declared insolvent in August 1989 and then by Exxon. In all, ESC spent about US$800m and Exxon about US$1,200m on the clean-up, which was completed in June 1992.

The primary cover
The largest underlying policy was the Exxon Global Corporate Excess ("GCE") policy, under which both Exxon and ESC were named insureds. This was divided into three sections. Section I covered loss of or damage to property; section IIIA provided protection against marine liabilities (including oil pollution but only if not covered by the International Tanker Indemnity Association ("ITIA") Rules; and section IIIB covered third party liabilities of a non-marine nature arising out of the insured's commercial activities in relation to the energy industry.

The extent of coverage under the three Sections differed. Section 1 provided US$600m per loss occurrence in excess of US$400m annual aggregate deductible, in excess of US$10m per occurrence deductible. Section IIIA and Section IIIB each provided cover of US$250m excess of an annual aggregate deductible of US$200m excess of a deductible per occurrence of US$10m. The Section III covers were provided in three layers, the first two of US$100m each and a further layer of US$50m. The first layer in each case was subject to a combined single limit for claims under Section III A and B.

Under Section I (and "*subject to the Basis of Recovery Article*"), insurers agreed to pay "*all losses incurred by the Insured as a result of physical loss or damage to Property of any kind owned by the Insured or property of others held in trust or for which the Insured may have assumed responsibility or for which the insured has an obligation to insure, repair or replace*". In addition, insurers agreed to indemnify the insured for all sums which the insured paid or incurred as costs or expenses on account of (amongst other things) "*Removal of or*

attempted Removal of Debris or Wreck of Property and/or Residential Structure covered hereunder". The Basis of Recovery Article confirmed that recoverable loss under the policy included "*expenses incurred in removal or attempted removal of debris or wreck [of] property...*"

Section I went on: "*Notwithstanding anything contained as above there shall be no recoveries hereon for liabilities as described under the [Insured's] Liabilities Polices...*".

All three sections of the GCE policy included service of suit and arbitration clauses. Sections I and IIIA provided that, in the event of a failure to pay under the policy, insurers would, at the request of the insured, "*submit to the jurisdiction of any Court of competent jurisdiction within the State of New York*". If the option were exercised "*all matters arising hereunder shall be determined in accordance with the law and practice of [the court selected]*". The equivalent clause in section IIIB was slightly different, in that it referred to "*any court of competent jurisdiction within the United States*".

The arbitration clauses in sections I and IIIA provided that, in the event of a dispute, the matter "*may, upon the agreement of the parties*" be referred to arbitration, that any such arbitration would take place in New York and, to the extent arbitrators followed the rules of law, "*such law shall be that of the state of New York to the exclusion of all other laws*". The arbitration clause in section IIIB provided that any dispute "*shall at the request of either party*" be referred to arbitration and made no reference to New York law.

The reinsurance cover

The reinsurance was in Joint Excess of Loss Committee terms. These stated:
"*It is a condition precedent to liability under this contract that settlement by the Reassured shall be in accordance with the terms and conditions of the original policies or contract*".

In addition, the Claims Clause provided:
"*All loss settlements by the Reinsured shall be binding upon the Reinsurers, provided that such settlements are within the terms and conditions of the Original Policies and within the terms and conditions of this policy and the Reinsurers shall pay the amounts due from them upon reasonable evidence of the amounts paid being given by the Reinsured*".

The settlement

In October 1990, the Superior Court of the State of Alaska held that Exxon, as owner of the cargo, was under strict liability for all damage proximately caused by the oil spill. In 1991, the Federal Court in Anchorage awarded private claimants damages of US$287 million and US$5 billion in punitive damages, (later reduced to US$4 billion). In 1992, Exxon settled claims for clean-up costs, environmental damage and litigation costs, brought by the US Federal Government and the State of Alaska, for US$900 million.

In August 1991, Exxon commenced proceedings in Texas against Lloyd's underwriters, claiming under the Section IIIA policy. These proceedings went to trial, resulting in July 1996 in a final judgment against insurers for US$238m excess of the US$210m deductible, plus a further US$161m of interest.

Exxon claimed under all three sections of the GCE policy. In March 1996 (bearing in mind the likely reaction of a jury if the matter ever got to court), the primary insurers settled all Exxon's claims under the property cover (Section I) for US$300 million. In January 1997, they settled all Exxon's claims under the Section IIIA and IIIB policies for the global sum of US$480 million. The settlement agreement did not apportion that payment between the two policies.

The issues

The main issue before the court was whether Exxon was entitled to recover under Section I or Section IIIB. If they were not, no part of the payments under the Section I Settlement Agreement could be brought into the calculation of the ultimate net loss under the retrocessions between the claimants and the defendants and none of the payments under the Section IIIA and IIIB Settlement Agreement could be apportioned to Section IIIB for the purposes of the calculation of the ultimate net loss as between claimants and defendants.

There was also an issue as to the proper construction of the retrocession, namely whether the defendant retrocessionaires were entitled to the exclusion of liability under the Seepage and Pollution Clause in respect of all constituents of the ultimate net loss attributable to expenditure on cleaning up oil pollution on land.

There was also a further issue as to whether ESC, as distinct from Exxon, was entitled to recover from the Section I primary insurers at the time of the Section I Settlement agreement and, if it was, whether there was a settlement of insurers' liability to ESC. If there was no such liability or settlement, the claimants could not include in the ultimate net loss under their outward retrocession any part of the Section I settlement on the ground of primary insurers having made payment in respect of liability to ESC as co-assured with Exxon, as distinct from Exxon itself. This article does not deal with these issues in detail; suffice it to say that the judge found in favour of the defendants on both points.

Applicable law

The first question the court had to determine was which law governed the GCE policy? The policy pre-dated the Rome Convention on conflicts of laws, so the starting point was to look at whether the parties had made an express choice of law or whether one could be implied. It was accepted that, since the risk had been presented to the market as a single package, the likelihood was that the parties had intended that the same law would apply to all three sections.

The claimants relied on the service of suit and arbitration clauses to argue that New York law applied. The relevant provisions of the policies are set out in the paragraph headed "The Primary Cover" above.

But the service of suit clauses, the judge found, only gave the insured an option to choose the jurisdiction of the New York (or, under Section IIIB a United States) court. The choice of law, such as it was, was contingent on the insured being entitled to exercise that option and on actually doing so. If the insured made that choice, then whatever had been the applicable law of the contract would be varied by substituting one body of law for another. An unexercised option to select a body of law, could not, the judge held, normally give rise to more than a minimal implication that the contract was to be governed by that law (*Armadora Occidental SA v Horace Mann Insurance Co* [1977] 2 Lloyd's Rep 406).

As for the arbitration clauses, the judge noted that, in the case of the Section I and Section IIIA policies, they did not amount to binding arbitration agreements, being merely "agreements to agree". The fact that any such arbitration was to take place in New York and that the arbitrators were to apply New York law to the extent that they followed any rules of law could not, the judge said, "contribute to the process of implication any weight in favour of New York law". The same held true for the Section IIIB arbitration clause, even though this did provide an enforceable option to either party to refer any difference to arbitration. Although the arbitration was to be held in New York, there was no express choice of New York law and the arbitrators could abstain from following strictly the rules of law.

In this regard, the judge disagreed with the reasoning as to the proper law expressed (but obiter) by Mr Justice Clarke, as he then was, in the case of *Commercial Union Assurance*

PLC v. NRG Victory Reinsurance [1998] 1 Lloyd's Rep. 80. The judge preferred to follow the reasoning in the case of E.I Du Pont de Nemours & Co. and *Endo Laboratories Inc. v. I. C. Agnew* [1987] 2 Lloyd's Rep. 585. In this case it was held that an unexercised option to select law and jurisdiction does not normally contribute to any implication as to the law which governs the contract at the time the contract is made.

The court, therefore, had to look at other features relevant to the applicable law. Although Exxon's headquarters were in New York, the service of suit clauses referred to New York or the US, the lead brokers were in New York and the policy provided for payment of premium and losses in US dollars, the factors in favour of English law outweighed these considerations. The Sections all referred to standard English clauses, the placing brokers were in London, the leading underwriter was in London, and most of the policies were negotiated in London and issued through Lloyd's and the Institute of London Underwriters ("ILU") in London. Where contracts of insurance are placed in the London market and issued in London, there is a strong inference – in the absence of strong contrary indications - that the policies are intended to be governed by English law (*E.I. Du Pont de Nemours and Co v I.C. Agnew*, above).

In this case, the judge was satisfied that, the service of suit and arbitration clauses carrying insignificant weight as to the inference regarding governing law, the pointers towards an implication of English law outweighed the pointers towards New York law. Thus, English law applied to all sections of the GCE policy.

This was a finding of crucial importance as the judge held, obiter, that if New York law had applied, the outcome would, on certain issues, have been different - in favour of the reinsurers, rather than the retrocessionaires.

Removal of debris

The next issue was one of construction. Did the phrase "*Removal of or attempted Removal of Debris*" in Section I of the GCE policy and in the Basis of Recovery Article cover pollution clean-up costs – see the policy wording set out in the section "The primary cover" above.

The defendant retrocessionaires submitted that the words "removal of debris of property" did not cover oil pollution clean-up costs because those words are not in their ordinary meaning wide enough to cover escaped liquid cargoes and in particular oil cargoes. Had the material intention been that cover should extend to such a risk, words incorporating an express reference to "pollution " would have been used.

The judge approached the problem of interpretation in three ways; first, to investigate the possible range of dictionary meanings; second to investigate the setting of the words in their contractual environment and third, to investigate the circumstances in which the contracts were negotiated, in particular the circumstances of the parties and the mutually known features of the market in which they were negotiating.

As to the first, the judge found that "*debris*" is not a word that normally applies to liquids - "All these dictionary definitions therefore contemplate broken solids as distinct from liquid or viscous substances", he said, at paragraph 88.

As to the second, it was a central plank of the Defendants' submissions that, in the field of insurance of oil companies and oil tanker operators, if in 1989 it was intended to provide cover against expenses caused by oil pollution, brokers and insurers would invariably draft policies to refer expressly to "pollution". In this connection, the wording of Sections IIIA and IIIB, the Liability Policies, was very relevant. The judge then reviewed that wording in detail and concluded that, where the policies were intended to relate to the provision or exclusion of pollution cover they referred to it as such. "It is thus", he said at paragraph 106, "intrinsically

improbable, that if the mutual intention had been to include cover under Section I for pollution clean-up, the parties would have used wording, such as "removal of debris", whose ordinary meaning does not usually connote the handling of any liquid or viscous substance."

As to the commercial environment in which the policies were negotiated, the judge referred to evidence of the state of the energy insurance industry in the years leading up to the time when the Exxon CGE policy was entered into, noting at paragraph 114 that "most of this evidence is well known to the judges of this court by reason of that specialist background which is one of the main reasons why those involved in international commerce are so willing to refer their disputes to its jurisdiction.". He concluded that, having regards to the structural and linguistic features of the GCE Policy and to the commercial background against which the risk was placed, including in particular the limited availability of market reinsurance cover for primary pollution clean-up risks, the relevant provisions of Section I were not to be understood as including the cost of clean-up of oil pollution.

But had the parties intended that the word should cover an oil spill of this sort? The judge thought not. If the parties had wanted the property section of the insurance to cover oil clean-up costs, they could easily have included such a provision. Instead, the liability sections of the policy made specific reference to pollution risks and liabilities, all of which indicated that the cost of removal of debris and liability for pollution were treated as two distinct areas of cover.

Even if this was not the case and Section I covered the clean-up costs, the judge was satisfied that the claim was excluded by the "*notwithstanding*" clause ("*Notwithstanding anything contained as above there shall be no recoveries hereon for liabilities as described under the [Insured's] Liabilities Polices…*") – namely, Section IIIA (Marine Liabilities) and Section IIIB (Non-marine Liabilities). The Defendants argued that there was cover under the Liability Policies for pollution clean-up costs, so that the exclusion applied. The effect of the "notwithstanding" clause was to avoid an overlap of cover between Section I and the Liability Policies, a point which had been provisionally recognised in the earlier case of *Commercial Union Assurance Plc v. NRG Victory Reinsurance Ltd,* above, where identical policies were in issue.

The claimants argued that "*liabilities*" should be construed strictly, so that, unless the clean-up costs had been incurred by Exxon because it was *liable* to compensate third parties or to indemnify the state of Alaska, expenditure for oil clean-up fell outside the scope of the clause. Exxon, it was argued, had incurred the costs of clean-up *voluntarily* and not in response to a claim for which it had been found liable. Such costs could not be recoverable under the liability sections of the policy and so escaped being caught by the "*notwithstanding*" clause. (Emphasis added)

In the Defendants' view, the "*notwithstanding*" clause was not to be so confined. Even if there were expenditure to mitigate an anticipated liability, albeit that liability were not at the material time ascertained by judgment on a claim or by settlement of a claim, then – provided that, but for the expenditure, a loss would have been caused by a peril insured under Section IIIA - there was cover under that Section. "Liabilities" was therefore to be construed as including the costs of mitigating a potential liability insured under the Section III Policies.

The judge agreed. The cover provided by Section IIIA specifically included "sue and labour" expenses, which meant that if and to the extent that the Insured incurred expenses of this nature connected with its legal or contractual liability as cargo owner for pollution or contamination, there would be cover under that Section. Any claim Exxon had (including any claim for costs incurred in mitigation of the loss) was in respect of its liability or anticipated liability and so fell within Section IIIA of the primary policy. As owner of the oil, it was strictly liable under Alaskan law for all damage proximately caused by the spill.

The judge concluded, at paragraph 136, that it was "commercially inconceivable that the wording of the *Notwithstanding* [clause] was designed to avoid coverage overlap in respect of liability but not in respect of the cost of avoiding apprehended liabilities." The sue and labour expenditure being part of the Section IIIA coverage, directly related to the occurrence which would otherwise have given rise to a liability strictly so-called, it must, he said, be within the scope of "liabilities" under the *Notwithstanding* clause. The clause was specifically designed to avoid an overlap between the property cover and the liability sections of the policy.

Since Exxon was not entitled to recover clean-up costs under Section I of the GCE policy, the Defendants were not bound to indemnify the Claimants in respect of the settlement of the Section I claim.

Section IIIB claim

This section covered liability "*in respect of all offshore and/or inshore and/or onshore Drilling, Production, Exploration operations and all transportation activities including all terminal and pipeline operations*" but specifically excluded claims made against the Insured arising out of the ownership or bareboat charter of any watercraft. This exclusion did not, however, mention cargo owner's liability. The claimants argued "*all transportation activities*" was wide enough to cover the ocean movement of oil in a tanker and such transportation was an operation of the Insured.

In addition, an endorsement No.2 covered liability for.... damage to third party property caused "*directly or indirectly by seepage, pollution or contamination arising out of the operations of the Insured*". This cover went on to include the costs of clean-up of seeping, polluting or contaminating substances emanating from the operations of the Insured, but excluding the costs of "repairing replacing, redesigning or modifying *the offending facility*." [Emphasis added] The Claimants maintained that Exxon's consignment of oil cargo for ocean carriage on board the Exxon Valdez was an "operation" of the Insured within the clause, out of which the liability to pay damages for oil pollution arose, and that the negligence of her crew (in allowing the vessel to ground) did not have the effect of breaking the necessary chain of causation.

The Defendants submitted that Section IIIB was essentially a non-marine third party liabilities policy and, as such, was not designed to provide cover in respect of marine ocean transportation as distinct from relatively minor transportation associated with or relating to exploration, drilling or production. As for the cover under Endorsement 2, the Defendants submitted that the reference to facility meant that any such pollution or contamination must emanate from a specific location where a "facility" of the Insured was situated. A vessel engaged in ocean transportation was not such a facility.

In approaching these issues, the judge emphasised the importance of the overall structure of the GCE policy. This was clearly intended to prevent any overlap between the three sections. In those circumstances, was it to be inferred from the terms of Section IIIB that Exxon was to have the benefit of cover of a scope which overlapped with that already granted to it as cargo owner in respect of marine liability risks under Section IIIA?

Although "*transportation activities*" was capable of including marine transport, the judge concluded that the watercraft exclusion in Section IIIB and other factors indicated an intention to confine all marine transportation claims to Section IIIA. From this, the judge held that a construction of the words in context that confined them to carriage specifically associated with drilling, production and exploration work accorded more closely with the structure of the cover and its division into the three policies, including a marine and non-marine liability risks policy. As for the cover provided by Endorsement 2, the judge held that the word "*operations*" was not wide enough to cover consignment on board an oil tanker for ocean carriage and should be confined to conduct of the Insured in relation to a static

"facility" in a particular place, as advocated by the Defendants. It covered pollution or contamination emanating from a range of industrial activities conducted by the Insured and closely associated with some industrial facility of the Insured, but not ocean transit on board a vessel.

Had this been otherwise, the judge held that the negligent navigation of the Exxon Valdez would not have broken the causal link between the consignment of the oil on board her and the resulting casualty giving rise to the pollution claim and clean-up expenses.

The Seepage and Pollution exclusion

In any case, the retrocession policies included a Seepage and Pollution Exclusion clause which excluded loss arising from seepage and pollution "*on land*", unless such risks were insured on a sudden and accidental basis (which, the Defendants contended, was not the case under the GCE wording). However, the Exclusion clause did not by its terms apply to coverage against liability under, amongst others, the Offshore Pollution Liability Agreement ("OPOL") or Protection and Indemnity policies against "*seepage, pollution or contamination.*" The OPOL Agreement is an agreement under which operators of offshore facilities used in connection with exploration for, or the production of, oil and gas agree to share the cost of liabilities arising from a discharge of oil from an offshore facility.

The Defendants maintained that, since the vast majority of the clean-up costs incurred by Exxon related to contamination of the land as opposed to the sea, such costs were excluded by this clause, the phrase "on land" signifying the place where the effect of pollution or contamination is *located.* The Claimants submitted that the clause applied only where the seepage, pollution or contamination *originated* from a source on land. This was indeed the construction of the clause adopted by Mr Justice Clarke, as he then was, in the case of *Commercial Union v. NRG Victory Reinsurance*, referred to above.

Had it not been for the disapplication of the exclusion to OPOL liabilities and the coverage for oil pollution within P&I policies, the judge would have preferred the construction adopted by Mr Justice Clarke. As it was, however, to adopt such a construction would render the disapplications "completely inexplicable", since liability under OPOL could not arise except in respect of contamination emanating from a source not on land. Reference to the P&I Policies (which deal exclusively with liabilities arising out of the operation of ships) pointed in the same direction. Accordingly, the judge held that the exclusion referred to seepage, pollution or contamination which *affected* land, whether it *originated on land or offshore.* As such, the clause provided a good defence to a claim under the retrocession for clean-up costs relating to the pollution or contamination of land.

This issue was, of course, relevant only if the judge were wrong in holding that Exxon were not entitled to recover their clean-up costs under either Section I or Section IIIB.

The impact of New York law

Had, contrary to the judge's finding, the relevant policies been subject to New York, rather than English, law, the outcome in relation to certain issues would have been different.

Thus, the judge found that, under New York law, the words "removal of debris of property" under Section I would probably be held to include oil pollution of the sea and shoreline, there being precedents to this effect in the cases of *Lexington Insurance Co. v. Ryder System Inc.* 142 Ga. App. 36 and *Antilles Steamship Co. Ltd. v. American Hull Insurance Syndicate*, 733 F.2 195. However, the judge found that on balance, a New York court would hold that Exxon's claim under Section I was barred by the *notwithstanding* clause, there being cover under Section IIIA for expense incurred in clean-up in anticipation of liability that would have been incurred, had clean-up been left to the Alaskan state.

As regards the claim under Section IIIB, the judge concluded with some difficulty, that a New York court would treat the words as wide enough to cover consignment on board an ocean tanker and as not limited by their close association with the industrial processes of exploration, drilling and production. He did not, however, think that there would be any independent coverage under Endorsement 2.

The judge did not express any view as to how a New York court might interpret the *on land* provisions in The Seepage and Pollution exclusion clause, but it appears that he believed that his views on this issue would be followed in New York – see Summary, 7 below.

Summary
The judge's findings can be summarised as follows.

1 The three policies comprising the GCE policy were all governed by English law and not by the law of the state of New York.

2 Oil pollution clean-up expenses were not within the coverage provided to Exxon by Section I of that policy, the "property" section. Even if they were, because there was coverage for such expenditure under Section IIIA, recovery under Section I was prevented by the *notwithstanding* clause.

3 There was no cover in respect of Exxon's clean-up expenses under either Section IIIB or under Endorsement 2 to that section.

4 The Seepage and Pollution Exclusion, excluding loss arising from pollution "on land", would in any event exclude the Defendants' liability since its scope extended to pollution and contamination affecting land which originates from a source offshore.

5 Had it been necessary to apply New York law, Exxon would not have been entitled to recover under Section I because, although "removal of debris of property" would be held to extend to removal of oil residues in this case, Exxon's recovery would be barred by the *notwithstanding* clauses.

6 However, Exxon would have been entitled, under New York law, to coverage under Section IIIB.

7 But even under New York law, recovery under Section IIIB would have been excluded by the Seepage and Pollution Exclusion clause incorporated into many of the retrocession contracts.

1 [2004] EWHC 1033 Comm

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