



Client Alert

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Reinsurers breathe a sigh of relief as the House of Lords ends a year of uncertainty for the interpretation of "back-to-back" contracts - but have the Law Lords simply stored up more trouble for the future?

On the day that the House of Lords brought down the curtain on centuries of judicial law-making, the Law Lords also emphatically overturned the decision of the Court of Appeal in the case of *Wasa & AGF -v- Lexington* and ended another long-running legal saga - with significant implications for the London reinsurance market.

The House of Lords has reaffirmed that the fundamental significance of the period clause in a reinsurance contract is in certain circumstances sufficient to trump the general presumption that a proportional facultative reinsurance cover subject to English law will be interpreted consistently with the underlying cover, even where the direct insurance is subject to a different governing law. In so doing, their Lordships have provided greater certainty for reinsurers, and the guarantee that they will not be found liable to a cedant in respect of losses arising outside the period of cover provided by the reinsurance unless that outcome has clearly been agreed at the outset.

We examine here the background to the case, the House of Lords' reasoning, and the practical implications for the markets.

Background

Lexington insured Alcoa, a US-based aluminium producer, under a property damage insurance policy for the 3-year period 1 July 1977 to 1 July 1980. Whilst the Lexington insurance contained no express provision as to governing law, like many US policies, it contained a Service of Suit clause permitting proceedings to be brought against insurers in any competent court in the United States.

At the same time as issuing the cover to Alcoa, Lexington had arranged a proportional facultative reinsurance cover for the same 3-year period on the standard London market slip on substantially the same terms ("and/or as original"). The reinsurance contract contained a "follow the settlements" clause and mirrored the insurance contract in all material respects save that it was impliedly governed by English law.

In December 1992, Alcoa brought proceedings in the State of Washington against a number of insurers, including Lexington, in respect of environmental damage at sites within and outside the US. In some instances, the claimed damage dated back to the 1940s.

In the absence of an express governing law clause in the insurance, it fell to the Washington State courts to determine the governing law which, applying the State of Washington's own conflict of laws rules, decided that the law of Pennsylvania applied to the determination of the coverage dispute. Interpreted in accordance with Pennsylvania law, which took a wide, purposive approach to insurance coverage for pollution-type liabilities, it was decided that the very broad language of the insuring provisions of the policy, and the absence of any limitation as to time of the physical loss or damage to property, meant that so long as some of the damage "manifested" itself during the 3-year period of Lexington's cover, all the damage could be recovered from insurers, whether or not it occurred before, during or after the period of insurance. Subsequently, Lexington settled with Alcoa in the sum of US\$ 103 million and sought to recover from its reinsurers, including Wasa & AGF.

The dispute

On presentation of the loss by Lexington, Wasa & AGF - alone among the London market reinsurers and representing 2.5% of the slip - declined to pay. They argued that, as a matter of English law, a reinsurer can only be held liable under a "losses occurring" policy in respect of the costs of remedying damage which occurred during the period of the reinsurance cover. Because the liability imposed on Lexington by the

Supreme Court of Washington was in respect of damage occurring outside that period, reinsurers said that it could not fall within the risks reinsured under the reinsurance contract.

Lexington relied on the previous House of Lords decision in the case of *Forsikringsaktieselskapet Vesta -v- Butcher [1989]* ("*Vesta*") and the Court of Appeal in *Groupama -v- Catatumbo [2000]* ("*Catatumbo*"), to argue that the "back-to-back" nature of the insurance and reinsurance meant that the reinsurance cover must be interpreted consistently with the meaning of the underlying contract, irrespective of the governing law of the reinsurance contract. This meant, according to Lexington, that reinsurers must be taken to have accepted the risks associated with the underlying cover which clearly provided for disputes to be resolved in the US, even if the liability which ultimately arose from those risks was one which would not have been recognised under English law.

Reinsurers avoid liability

At first instance, Mr Justice Simon disagreed with Lexington. He held that the period provision in the reinsurance contract was of fundamental and overriding importance when considering whether or not losses fell within the scope of the reinsurance cover. It was not one of the terms of the reinsurance which could be subject to a *Vesta*-type "back-to-back" interpretation. Unlike in the *Vesta* and *Catatumbo* cases, where the governing laws of the direct insurance contracts were clear on the face of the contracts, the absence of an express governing law provision in the Lexington cover meant that there was no identifiable system of law which could be used to interpret the scope of the period clause in the insurance in the specific context of environmental damage stretching back over a period of decades.

In the circumstances, reinsurers were entitled to rely on the relative certainty afforded them by the clear meaning of the period clause in their contract provided by English law, which all parties accepted was the governing law of the reinsurance, with the result that reinsurers were liable only in respect of damage which could properly be said to have occurred during the 3-year period of the reinsurance contract.

Lexington fights back

On appeal by Lexington, the Court of Appeal rejected the first instance decision and reaffirmed the primacy of the "back-to-back" principle. Wasa & AGF were ordered to pay. In the view of the Court of Appeal, reinsurers who had agreed to reinsure a US company must have intended that, where they used the same words in the reinsurance as in the underlying cover, those words would bear the same meaning in both contracts.

In reaching this conclusion, Lord Justice Sedley observed that the practice and vocabulary of reinsurance law had long since reflected the commercial reality that what is reinsured is the insurer's own liability. It followed from this that an aspect of the risk reinsured was that a US court might find the reinsured liable in circumstances which would be surprising to reinsurers.

In addition, Lord Justice Longmore drew support for this outcome from his conclusion that, if reinsurers had considered what would be the system of law applicable to the Lexington insurance in the context of the losses in question when the reinsurance was placed in 1977, they would have concluded that the applicable law would be Pennsylvania law and, applying that system of law, it was at least possible that they would ultimately be asked to indemnify under the reinsurance in respect of the kind of liabilities which in fact arose.

Back to the future for reinsurers

Wasa & AGF took the case to the House of Lords. Delivering the leading judgment of a unanimous court, Lord Collins started by confirming the general "presumption" that a proportional facultative reinsurance subject to English law would be interpreted as "back-to-back" with the underlying cover and would be interpreted consistently with it. This was the "usual" position in such cases as a matter of the obvious commercial intentions of the parties, and was supported by the previous decisions of the English courts in *Vesta* and *Catatumbo*.

However: that was not the end of the story. Lord Collins considered that the present case was different from the *Vesta* and *Catatumbo* cases in certain critical respects. In the earlier cases, reinsurers had sought to take "technical" and "wholly unmeritorious" points to attempt to avoid indemnifying their cedants. They had argued that a warranty which was subject to a foreign law in the underlying cover (Norwegian law in *Vesta*; Venezuelan law in *Catatumbo*) and which was incorporated in the same terms in the English law reinsurance should not bear the same meaning in both contracts.

According to reinsurers, a breach of warranty which was in any event non-causative of the underlying loss should still operate to preclude an indemnity under the reinsurance as a result of the application of English

law, even where that was not the result at direct level under the relevant local law. The judges in those cases rejected that approach. They had little difficulty in deciding that the warranty had to be interpreted consistently at reinsurance level and at underlying with the result that reinsurers had to follow their cedants' settlements.

Lord Collins said that the present case was "more difficult" than the *Vesta* and *Catatumbo* cases. This was not a dispute where reinsurers were relying on a mere technicality to avoid payment - this case concerned the application of a fundamental provision in any "losses occurring" insurance contract; namely the period clause. Lord Collins considered it beyond argument in English law that where an insurance or reinsurance contract provides cover for loss or damage to property on an occurrence basis, the insurer (or reinsurer) is liable to indemnify the insured (or reinsured) in respect of loss and damage which occurs within the period of cover - but not in respect of loss and damage occurring either before inception or after expiry of the cover.

Unlike in the *Vesta* and *Catatumbo* cases, where the governing laws of the underlying contracts were clear from the outset, it was not possible in the present case for reinsurers to have worked out when they issued the reinsurance that they might become liable to indemnify Lexington in respect of losses occurring outside the period of the cover as a result of a decision of the Washington State courts applying Pennsylvania law. In the absence of an identifiable system of law governing the underlying contract which would provide reinsurers with this degree of predictability from the outset, reinsurers were entitled to rely on the law governing their own contract as to the interpretation of the period clause in the reinsurance. Lord Collins concluded that there was "no principled basis" for treating the scope of the 3 year reinsurance as the same as the insurance, which had been interpreted under the law of Pennsylvania not to contain any limitation as to time of the loss.

In reaching this conclusion, the House dismissed Longmore LJ's reasoning that reinsurers could have predicted the Washington State Court's decision by application of the relevant conflict of laws rules. Lord Collins decided that the issue was a matter of the proper interpretation of the terms of the reinsurance contract and there was no need to consider any question of the conflict of laws. In any event, Longmore LJ had got it wrong in his own application of the conflict of laws rules; a correct application of those rules pointed towards the application of Massachusetts law rather than Pennsylvania law. All this served simply to underline the conclusion that reinsurers could not have predicted with any degree of certainty, at the time they issued the cover, the scope of the liability which they would ultimately be asked to indemnify.

Against that background, the House of Lords could not accept that the parties to the reinsurance had implicitly agreed that the reinsurance would cover whatever liabilities the cedant found itself liable for, under whatever system of law might eventually be applied to the underlying cover. To decide otherwise would be effectively to translate the rebuttable presumption of "back-to-back" cover laid down in the *Vesta* and *Catatumbo* cases into an immutable rule of law that a proportional facultative reinsurance would always respond. There was no justification for treating the *Vesta* presumption as applicable in all circumstances - certainly not so as to override so clear a temporal limitation as provided by the 3 year period clause in the reinsurance.

A victory for common sense?

The House of Lords decision will inevitably be welcomed by London market reinsurers, who can now be confident that, where an English law reinsurance is "back-to-back" with an underlying cover subject to a foreign governing law, they will nonetheless only be liable for losses arising within the period of cover they have written unless it is possible to demonstrate that a different outcome has been agreed; and they can confidently rate their covers by reference to the period of insurance they are providing.

Reinsurers will no doubt point to the "very uncommercial consequences" which Lord Collins considered would follow if Lexington were right. These included the fact that Lexington would be able to argue that reinsurers would still have had to pay the entirety of the loss, no matter how short the period of cover, so long as some loss manifested itself within that period. In the context of environmental pollution exposures dating back decades, the result would have been that the reinsurance was effectively exhausted the moment it was issued - something the parties could not realistically have intended.

However, their Lordships' reasoning is not without its potential difficulties. In particular, the decision begs the immediate question: what other terms of a facultative reinsurance - apart from the period clause - might be considered sufficiently fundamental to trump the presumption of "back-to-back" cover in this type of situation? It is not inconceivable that such questions might be put to the courts in future as to the proper effect of provisions such as aggregation or "any one event" clauses, which are central to defining the risk under any contract, and where it is certainly not fanciful that different systems of law might reach differing interpretations. Only time will tell.

Practical implications

The case suggests that where, firstly, an overseas insurer's direct cover is silent as to its governing law and, secondly, the insurer's facultative reinsurance is subject to English law (either expressly or impliedly), a cedant can no longer be confident that its reinsurers will necessarily have to indemnify to the full extent of the cedant's own liability.

From reinsurers' perspective, the two central distinguishing factors in this case will be very familiar to them: first of all, the standard US Service of Suit clause in the direct cover; and secondly, the kind of environmental long-tail exposures which have given rise to controversial theories of legal liability, particularly in the US (epitomised by the "triple trigger" in asbestos insurance coverage cases). Where these factors combine, reinsurers whose contracts are subject to English law will no doubt pay closer attention in future to their overseas cedants' loss presentations to satisfy themselves that the losses they are asked to indemnify properly arise during the period of the reinsurance cover as a matter of English law.

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