# IN ITS LAST MAJOR INSURANCE LAW RELATED DECISION BEFORE BEING REPLACED BY THE SUPREME COURT, ENGLAND'S HOUSE OF LORDS ALLOWS REINSURER'S APPEAL IN *WASA V. LEXINGTON* AND DISTINGUISHES IT FROM THE PRESUMPTION THAT INSURANCE AND REINSURANCE CONTRACTS ARE TO BE CONSTRUED AS "BACK TO BACK"

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In *Wasa International Insurance Company Ltd v Lexington Insurance Company; AGF Insurance Ltd v Lexington Insurance Company [2009] All ER (D) 328 (Jul)*, the House of Lords had to decide the extent to which the facultative reinsurance should be construed under English law as being "back to back" with the underlying insurance policy. It held that the insurance and reinsurance contracts were not "back to back" where, at the time of the conclusion of the insurance contract, there was no identifiable choice of law to govern the insurance policy and the reinsurers therefore could not have contemplated a specific construction of its terms.

### Facts

In Wasa v Lexington, Aluminium Co of America ("Alcoa") and its subsidiary, Northwest Alloys, Inc ("NWA"), were insured by, amongst others, a Massachusetts insurer, Lexington Insurance Co ("Lexington"), under an American "all risks difference in conditions" ("DIC") property damage insurance policy issued for a 3-year period from 1 July 1977 to 1 July 1980. The insurance policy did not contain a specific choice of law clause but incorporated a standard US Service of Suit clause. Lexington reinsured the risk in the London reinsurance market with Wasa International Insurance Co Ltd ("Wasa") and AGF Insurance Ltd ("AGF") on the same terms and conditions 'as original' including, specifically, the 3-year policy period.

In the 1990s Alcoa and its subsidiary were required by the US Environmental Protection Agency to remove pollutant waste from various sites occupied by Alcoa since the 1940s and to restore the sites. The companies incurred substantial costs and looked to their property damage insurers for full reimbursement of the costs incurred. Alcoa subsequently brought proceedings against its insurers in the state of Washington seeking entitlement to indemnity.

The trial court determined that, of several possibilities, it was the law of Pennsylvania that applied to the insurance contract, *"largely because Alcoa's headquarters are located in Pittsburgh"*. The application of Pennsylvania law was not disputed by the parties. The Judge found that Alcoa could recover only remediation costs for damage which occurred during the policy period and awarded only partial remediation costs. Alcoa appealed.

Hearing the appeal, the Supreme Court of Washington, applying Pennsylvania law, reversed Judge Learned's decision and, applying the "triple trigger principle", held that Alcoa was entitled to recover the full costs of

remediation provided that at least some of the damage had occurred at the relevant site during the years the insurers were insuring the risk.

The Supreme Court further held that under Pennsylvania law, all insurers were jointly and severally liable for all losses which flowed from the property damage even if the damage occurred before (or after) inception, because the policies were not limited as to time.

The effect of the Supreme Court's judgment was that Lexington was liable for coverage of all damage 'manifesting' itself during the relevant insurance period, although such damage had 'occurred both before and during' that period or had 'begun spreading' or 'start[ed]' before that period.

Lexington accepted the ruling and settled the claim with Alcoa for some US$103 million and looked to its reinsurers, Wasa and AGF, for indemnification. Reinsurers refused to pay on the basis that the reinsurance policy was governed by English law and that, as a matter of English law, reinsurers could only be liable for the costs of remedying damage to property which had actually occurred during the policy period.

Wasa and AGF commenced proceedings in the English court seeking a declaration that they were not liable to indemnify Lexington. Lexington counterclaimed for an indemnity or damages.

The judge at firs instance upheld the reinsurers' contention that the reinsurance was impliedly governed by English law and found that they could not be liable for the costs of remedying damage which had occurred before or after the insured period.

Subsequently the Court of Appeal, hearing Lexington's appeal, overturned the judgment at first instance and held that, following the principle established in *Forsikringsaktieselskapet Vesta v Butcher [1989] AC 852 ('Vesta') and Groupama Navigation v Catatumbo CA Seguros [2000] 2 Lloyd's Rep 350 ('Catatumbo')*, the reinsurance had to respond because the reinsurance contract had to be construed "back to back" with the underlying policy. In other words, the wording relating to the period of cover was to be given the same meaning in both insurance and reinsurance contracts. The Court of Appeal also agreed with the Supreme Court of Washington's decision to apply the law of Pennsylvania in interpreting the primary insurance and implicitly agreed that the same law should also apply to the interpretation of the reinsurance.

The reinsurers appealed to the House of Lords on the grounds that whatever the position under the insurance contract, as a matter of interpretation, the reinsurance only covered property damage occurring during the 3-year period. The House of Lords were asked to rule on whether the English law reinsurance mirrored or followed the American insurance, so as to oblige Wasa and AGF to indemnify Lexington.

## Analysis

The House of Lords confirmed that the starting point for an analysis of the extent of reinsurers' liability under English law is a "back to back" construction of the insurance and the reinsurance contracts as developed in *Vesta* and *Catatumbo* and that the same wording contained in both contracts should be given the same meaning.

The Lords, however, distinguished *Wasa v Lexington* from the general presumption developed in the *Vesta/Catatumbo* line of precedent. They based their reasoning on the observation that when different laws govern the insurance and reinsurance contracts there are no conflict of law rules applicable to this problem and the contracts therefore have to be interpreted independently from one another under each chosen law. However, in *Wasa v Lexington* the underlying policy did not contain a specific choice of law clause. Pennsylvanian law was determined as the applicable law of the underlying policy by the Washington Court retrospectively and many years after the insurance contract was made and both damage and loss had occurred. The Lords observed that in 1977, when the insurance contract was made, there was thus no identifiable system of law which would have provided a basis for anticipating that the scope of risk covered by the insurance contract was different from that of the reinsurance contract.

Consequently, the Lords argued that Pennsylvanian law could not be applied for interpreting the terms of the reinsurance contract. The reinsurance contract therefore had to be construed according to English law alone which does not allow for an allocation of liability outside the scope of the policy period.

Despite the House of Lords' decision, the presumption of "back to back" cover in proportional reinsurance remains valid in cases where there is a clear choice of law in the underlying policy. While the decision undoubtedly provides much needed certainty, the ultimate conclusion reached by the Lords is not as far-reaching as anticipated by some in the London reinsurance market. It is also not immediately apparent why a determination of the applicable law by a court which has jurisdiction over the matter and applies comprehensible logic should be treated differently from an express choice of law made by the parties. Both reflect the parties' intention at the time the insurance contract was made. When deciding to reinsure a risk that has no express choice of law clause, reinsurers could be seen to have accepted the risk of uncertainty as to the applicable law.

## Learning Point:

The well established principle that reinsurance contracts are to be construed as being "back to back" with the underlying insurance contract remains. The House of Lords judgment in *Wasa* does not dispose of the *Vesta/Catatumbo* line of precedent but rather distinguishes it.

First, the reinsurers were unable to determine the extent of their potential liability under the reinsurance contract. Secondly, and perhaps more critically, the House of Lords gave thought to the practical and commercial consequences of exposing reinsurers to an almost limitless period of liability.

This is perhaps the greatest distinction to be made between the US and English rulings. The Supreme Court of Washington, applying the law of Pennsylvania, placed a dramatically greater liability upon insurers; whereas, the House of Lords refused to construe the reinsurance contract to mean that it would respond to any risk, up to the reinsurance limit, but to an almost limitless reinsurance period.

In future *Wasa* will apply to cases where, at the time of the underwriting, it was not made clear which choice of law would apply to the underlying policy. It seems likely that *Wasa* will encourage insurers and reinsurers to determine clearly a choice of law at the outset when the insurance and reinsurance contract are made.