Case Summary

Wasa International Insurance v Lexington Insurance Co

[2009 UKHL 40]
October 2010

Summary

This case deals with the significance of governing law in a reinsurance contract and arises from an appeal filed by WASA and AGF Insurance (Reinsurers) against the decision of the Court of Appeal, wherein they were held liable to indemnify Lexington (Insurer) for a claim settled with Alcoa (Insured).

We discuss the implications of the decision passed by the House of Lords.

The facts

The Aluminum Company of America (Alcoa) of Pennsylvania and its subsidiary, Northwest Alloys Inc (NWA) were insured by Lexington, a Massachusetts insurer under an American "all risks difference in conditions" (DIC) property damage insurance policy issued for the period from 1 July 1977 to 1 July 1980.

The insurance contract did not specify a governing law but contained a standard US service of suit clause and later was determined to be subject to the law of Pennsylvania.

Lexington reinsured the risk with Wasa and others under a facultative policy that provided cover in respect of all risks of physical loss or damage to the property insured occurring from 1 July 1977 to 1 July 1980. The reinsurance contained a full reinsurance clause and a follow the settlements provision, and was expressly governed by English law.

The insurance and reinsurance contracts were back-to-back save for the governing laws.

Lexington was found liable to Alcoa under the terms of the insurance contract by the Supreme Court of Washington. The judge applied Pennsylvania law with the result that Alcoa was able to recover the full costs of remediation of pollution damage at any particular site provided only that some damage had occurred at the relevant site during the years when Lexington was on risk. Lexington was therefore found liable to pay for the cleanup costs of pollution and contamination damage to Aloca's 58 sites occurring during a 44-year period from 1942 to 1986. Lexington looked to recover from reinsurers on the same basis arguing that the strong presumption that liability under a proportional facultative reinsurance was coextensive with liability under the original policy meant that the reinsurance contract must be construed in the same manner as the original insurance.

Reinsurers resisted 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 costs of remedying damage to property which actually occurred during the period when they were on risk. At first instance reinsurers were successful but the decision was overturned in the Court of Appeal which found that the period of cover should receive the same interpretation in the insurance and reinsurance contracts.

Case Summary

The House of Lords Judgment

The House of Lords overturned the Court of Appeal's judgment on a unanimous basis. They agreed with the reinsurers' position and applied English law to the interpretation of the policy period in the reinsurance.

The question was whether the provision for the policy period in the reinsurance was to be given the effect it has under English law, or whether the parties must be taken to have meant that the reinsurance was to respond to all claims irrespective of when the damage occurred and irrespective of the period to which the losses related.

It was observed that, if the reinsurance in question were to be construed according to purely English law principles it would not have a meaning or effect similar to that which the Washington Supreme Court gave to the original insurance. The only property damage which the reinsurance, construed according to purely English law principles, covered was property damage occurring during the three-year reinsurance period.

The relevant language of the insurance and reinsurance was identical (save that the reinsurance contract was governed by English law). Lexington submitted that the contracts should be treated as back-to-back and a mere difference in governing law should not lead to any other result. Lexington cited the cases of ***Vesta v Butcher***[1] and ***Groupama v Catatumbo***[2]. In *Vesta*, the reinsurance was subject to English law while the insurance was subject to Norwegian law. Both included a warranty in the same terms. Under Norwegian law, breach of warranty was only relevant if it caused the loss, while under English law breach of warranty automatically discharged reinsurers from liability. The House of Lords in *Vesta* held that by virtue of the back-to-back nature of the reinsurance, the warranty was to be given the same significance in English law as in Norwegian law. Similarly, in *Catatumbo* the same effect was given to a warranty in the English reinsurance as in the Venezuelan law underlying insurance. But Lord Mance noted that in both *Vesta* and *Catatumbo*, it was possible at the time when the reinsurance was placed to identify the foreign law which would govern the insurance.

Lexington submitted that all that mattered was that the Washington Court determined under its conflicts principles that Pennsylvania law governed. But Lord Mance noted that the Washington Court's decision was reached in the context of large scale litigation involving a wide range of insurers, insurances and periods and the Washington Judge's decision must be viewed in that light. Pennsylvania law was 'the one commonality between all the sites and all the defendants' and against that background the Judge determined that Pennsylvania law should apply. But in Lord Mance's view, the choice of Pennsylvania law could not be regarded in any way as predictable at the time when the reinsurance was placed. In that sense, the case materially differed from both *Vesta* and *Catatumbo*, in that there was no 'legal dictionary' which reinsurers could access to determine the interaction and operation of the terms of the insurance and reinsurance.

Lord Collins said that in principle the relevant terms in a proportional facultative reinsurance (and in particular those relating to the risk) should be construed so as to be consistent with the terms of the insurance contract on the basis that the normal commercial intention is that they should be

1 [1986] 2 All ER 488

2 [2000] 2 Lloyds Rep 350

back-to-back. However, where the insurance contract and the reinsurance contract are governed by different laws, it remains a question of construction of each contract under its applicable law as to what risk is assumed, and there is no special rule of the conflict of laws which governs the consequences of any inconsistency.

Based on the above mentioned reasons, the appeal by the Reinsurers was allowed by the House of Lords.

Implications of the Judgment

The biggest implication of judgment is that the parties to a multijurisdictional reinsurance contract should take care regarding the governing law clause in the reinsurance contract. If different from the underlying insurance contract, it could lead to different results than what is arrived at under the insurance contract and cedants might unwittingly find themselves without cover.

The underlying insurance contract should itself be ideally subject to an identifiable governing law.

Further, the House of Lords' judgment rejected the proposition that where the language of the reinsurance and direct policies is identical, the contracts should be treated as being back-to-back, saying instead that the construction of a particular reinsurance contract should depend on its relevant background and surrounding circumstances. It seems therefore to have increased uncertainty about the extent to which parties can assume reinsurance will be treated as back-to-back.

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