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THE BACK TO BACK PRESUMPTION IN PROPORTIONAL REINSURANCE - THE US 2ND CIRCUIT GOES AWRY

The United States Court of Appeals for the 2nd Circuit has considered whether, under English law, a proportional reinsurance contract was back to back with the underlying insurance which covered pollution losses on an "all sums" basis. In this briefing we discuss the judgment and how the decision has gone awry

Introduction

There is a strong presumption in English law that a facultative proportional reinsurance contract is to be construed on a back to back basis with the terms of the underlying insurance, the parties' objective intention being to cover part of the same risk as the underlying insurance.

This presumption has been of such strength as to change the English law meaning of reinsurance terms, express or incorporated through a full reinsurance clause, to that of the foreign law of the underlying insurance, the legal analysis being that the parties' objectively intended to use a foreign law dictionary at inception to interpret the reinsurance contract and thus ensure it was back to back.

What though if the reinsurance term is fundamental and has a settled meaning under English law, such as a losses occurring during ("LOD") coverage trigger? And does it make a difference if the foreign law has changed since inception, the law being treated as always having been such? The majority in the well-known House of Lords decision in *WASA v Lexington*[1] left these questions open, resolving that case on the basis that the underlying governing law of Pennsylvania was not discernible at the time of the reinsurance contract.

The 2nd Circuit in the United States in *The Insurance Company of the State of Pennsylvania v. Equitas Insurance Limited*[2] has now sought to address these questions. In a thoughtful and balanced, but ultimately flawed, decision, the Court has found that an English law governed proportional reinsurance covering losses occurring during its policy period did cover reinsurance losses occurring outside that period on the basis that this was the effect of the underlying Hawaii law insurance, and even though no Hawaiian legal dictionary would have so identified at reinsurance inception.

The Facts

ICSOP provided umbrella liability insurance, written on an occurrence based trigger, to the Dole Food Company for the period 1968-1971 and subject to the law of Hawaii. Part of that risk was facultatively reinsured via a slip policy, albeit with J1 jacket, with a full reinsurance clause to what is now Equitas Insurance Limited. The parties proceeded on the basis English law governed the reinsurance and, as in *WASA*, that the reinsurance cover was likewise written on a LOD basis.

Dole settled claims by homeowners in respect of a housing development, which had been polluted over a continuous period of some 44 years starting in the 1960s. Hawaii is one of a number of US States which has now adopted (subsequent to the reinsurance) what is termed the "*all sums*" doctrine, a doctrine noted as "*surprising*" to an English lawyer by Lord Mance in *WASA*. Whilst the pollution damage is divisible, occurring both before and for some considerable time after the insurance period, the doctrine provides that the insurer is joint and severally liable to indemnify up to its policy limits for all the damage on the basis the insuring clause provides it is liable to indemnify for "*all sums*" for which the insured is itself liable.

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[1] [2009] UKHL 40

[2] Case No. 20-3559-cv (2d Cir. May 22, 2023)

Equitas refused to indemnify ICSOP other than on the basis of the relevant proportion of damage actually occurring during the reinsurance period, arguing that this construction of the reinsurance was fundamental to English law with English law prorating continuing pollution damage across its period[3]. On the basis of the approach in *WASA*, the presumption of back to back coverage should therefore be overridden. Further, or in the alternative, there was in any event no Hawaiian law dictionary at the time of the reinsurance contract on which an alternative construction of the reinsurance could be based.

The Decision

The 2nd Circuit set itself the task of resolving how the English Supreme Court would resolve the reinsurance claim under English law. The fundamental premise for its approach was its consideration by analogy of the "*Fairchild enclave*" chain of authorities (relating to mesothelioma as a result of exposure to asbestos), which it perceived by analogy established that the English Courts had been prepared to adopt the "*all sums*" approach in circumstances where the law on an employer's exposure had changed with retrospective effect. It therefore opined that whilst the position was not without doubt, the better view was that the reinsurance would be construed under English law on a back to back basis in accordance with Hawaii law as it stands today.

Analysis and Comment

It is necessary first to address the Fairchild enclave under English law, and the 2nd Circuit's view on it.

Mesothelioma is an indivisible injury. In other words, material exposure to asbestos does not in itself cause any injury at that time; it creates a risk of developing mesothelioma many years later at which point all the injury is actually suffered. The injury is not proportionate to the extent of the exposure, although the risk of injury is generally thought to be proportionate to materially the same exposure.

These facts historically rendered it difficult, if not impossible, for victims employed by a number of employers to identify which had, on the balance of probabilities, actually caused their injury in fact. Therefore, in 2002, in *Fairchild*[4], the House of Lords developed a new and unique rule of causation in tort to permit recovery for claimants. Any employer which had made a material contribution to the risk was to be treated as having actually caused it.

However, in a later case in 2006, *Barker*[5], the House of Lords decided as a matter of common law that although an employer had caused the loss, it was only to be liable to the proportionate extent to which it had exposed the employee to asbestos – as a quid pro quo for the relaxation of ordinary rules of causation in relation to that employer.

With the prospect of employees failing to recover in full, in particular due to employer insolvency, Parliament immediately stepped in and enacted the Compensation Act 2006, reversing *Barker* and making employers liable 100% for any exposure, prospectively where liability had not already been established or settled.

At insurance level, a number of Employers' Liability (EL) insurances are written with a damage/injury occurring during trigger, and accordingly victims where employers no longer existed or were insolvent faced a shortfall or failure in recovery. In *Durham*[6], a policy decision portrayed as an exercise in contractual construction, the Supreme Court found that all EL wordings were to be treated as having a damage/injury caused during trigger (i.e. an exposure-based trigger). Further, and more importantly, by a majority the Supreme Court found in *IEG*[7] that the EL insurer was liable to the employer for 100% of the loss in each year of exposure, namely to the same extent as the employer was liable to its victim. However, and creating a new right of contribution/recoupment, the insurer could recover from other insurers (or indeed the employer if uninsured) on a proportionate basis.

The EL insurances in *IEG* covered the employers' liability and, as noted in *WASA*, insurers generally take the risk of a change in law expanding the ambit of their insureds' liabilities (and the benefit where liability is reduced). The outcome protected victims, through placing the solvency risk of employers/insurers on insurers themselves. However, even then three of the seven Justices (led by Lord Sumption) dissented, and would have reverted to the common law position at insurance level due to the fundamental importance of the policy period of cover.

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[3] See *MMI v Sea* [1998] Lloyd's Rep IR 421 - unless particular loss can be proven at a particular time on the balance of probabilities.

[4] *Fairchild v Glenhaven Funeral Services Ltd* [2002] UKHL 22

[5] *Barker v Corus UK Ltd* [2006] UKHL 20

[6] *Durham v BAI (Run off) Ltd* [2012] UKSC 1

[7] *International Energy Group Ltd v Zurich Insurance Plc UK Branch* [2015] UKSC 33

What then of the position at reinsurance level? At that level, the policy decision of protecting the position of victims of mesothelioma is no longer applicable. The reinsurance is not a type of liability insurance of the insured but one of the underlying risk, and subject to the terms of the reinsurance itself.

IEG created a significant debate in the reinsurance market for many years. If the reinsured was liable for 100% of the loss in each year of exposure, could it not claim 100% from its reinsurers in a particular year (what became known as "spiking")?

This issue was finally resolved in *Equitas v MMI*[8].

The Court of Appeal found that the *IEG* majority line of jurisprudence should **not** apply at reinsurance level and "*we should revert to orthodoxy*" in circumstance where the position of the victim has been protected. The orthodoxy was that (1) insureds should not be able to elect which insurance to recover under and (2) the common law position as expressed in *Barker*. Some judicial contortions were required to reach this result, with the Court finding a term was to be implied into the reinsurances that reinsurance claims must be made in a manner which is rational, which in this context meant "*that they be presented by reference to each year's contribution to the risk, which will normally be measured by reference to time on risk unless in the particular circumstances there is a good reason (such as differing intensity of exposure) for some other basis of presentation*". The strength of the period of cover issue is such that "*all sums*" is inapplicable, despite the fact that the reinsured's own liability is established on such basis.

The 2nd Circuit, which appears to have engaged in its own research on English law, has mistakenly overlooked this reinsurance decision, commenting that "*[t]here is no reason to think [the fundamental importance of a policy period] would stop that majority [in IEG] from imposing joint-and-several liability on a reinsurer in the present circumstances either*.".[9] On its own logic, had the Court been aware of the *MMI* decision, it would and should have reached the opposite view.

Would that be the correct decision regardless? The answer is that it would be. The key is that the issue turns on a matter of policy construction of the reinsurance, where English law has not changed. That is fundamentally different to a liability insurance where there is a change in law in relation to the insured's duty. The risk still has to fall within the terms of the reinsurance. It is trite English law that contracts are construed as at the date of their formation (see per Lord Collins in *WASA*[10]) and matters occurring thereafter cannot affect their proper construction[11]. There was simply no legal dictionary the parties could have looked at in Hawaii, or indeed anywhere in the US, which would have identified "*all sums*" at the relevant time.[12] Put another way, even if a later decision changed the law with retrospective effect, no legal dictionary would have so identified at the time.

Nor are there any broader policy reasons, such as protecting victims of asbestos, which would persuasively suggest a different approach should be adopted. It is, of course, right that foreign reinsureds expect coverage to be back to back, and insurance is an important industry in the UK (a point made by Lord Collins in *WASA*). But reinsureds also expect the certainty of English law and may well also be reinsurers themselves (as here, ICSOP being part of the AIG group). As emphasised in *WASA*, a contrary view would have the extraordinary result of the reinsurer being liable in full even if it wrote and received premium for just one day of risk. No objective reinsured and reinsurer at the time of the Equitas reinsurance would ever have considered that a possibility under an English law governed reinsurance, whether written on a back to back basis or otherwise.

In conclusion, the 2nd Circuit decision should not be relied on as an accurate statement of English law.

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[8] [2019] 3 WLR 613

[9] The 2nd Circuit was it appears looking to how the Supreme Court would resolve matters as shorthand for English law. Even if that were not right, one of the members of the Court of Appeal in *MMI* is now in the Supreme Court (Leggatt LJ).

[10] It is to be noted that in *WASA* Lord Mance, in obiter dicta, refused to approve the approach of Longmore LJ in the Court of Appeal. Lord Mance stated that the reinsured could have specified the underlying governing law to seek to protect itself on back to back cover, but even doing so "*would not necessarily foreclose all argument."*

[11] Per Lord Parmoor in *Union Insurance Society of Canton Ltd v George Wills & Co* [1916] 1 AC 281:"*It is immaterial to the construction of the contract to consider subsequent events. The intention of the parties must be gathered from the language of the contract, the subject-matter, and the circumstances in existence at the time it was made*". See generally Lewison on the Interpretation of Contracts 7th Ed, Section 9.

[12] A more difficult question is whether English law would adopt the same approach to the period of cover if "*all sums*" has applied in Hawaii at the relevant time. It is likely that it would do so when squarely faced with the issue. See in particular per Lord Brown in *WASA*, who in the minority decided the case on the basis the English position would apply to the reinsurance come what may.

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