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INFORMED ANALYSIS AND OPINION
FOR INSURANCE PROFESSIONALS

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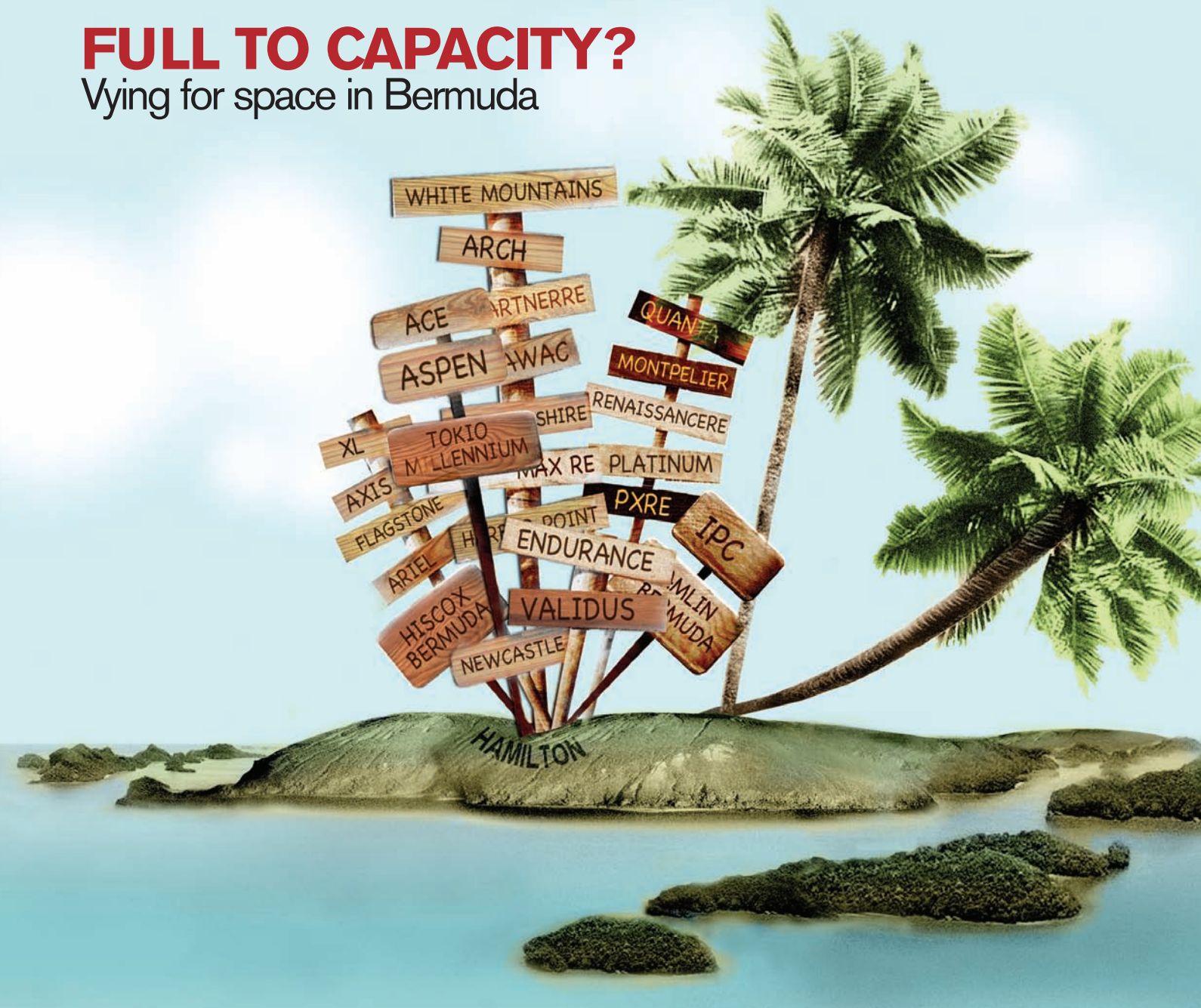

# Omission is not an option

**Peter Dunlop** reveals the dangers of failing to deal effectively with the issue of governing law.

**THE ISSUE OF A** policy's governing law may not feature too prominently in the minds of underwriters, who are primarily focussed on such commercial considerations as premium income, underwriting limits and outwards reinsurance. In the context of all risks group insurance policies reinsured in the London market, the importance of a governing law clause – and the perils of such a clause being omitted – have been re-emphasised in the recent decision of *CGU International Insurance Plc and Others v AstraZeneca Insurance Company Limited [2005] EWHC 2755 (Comm)*.

## THE CASE IN QUESTION

AstraZeneca, a UK company and one of the world's largest bioscience corporations, is engaged in the development and distribution of pharmaceutical and agrochemical products. The defendant, AstraZeneca Insurance Company Limited (AZIC), is a UK-based captive insurance company, wholly owned by AstraZeneca.

In 1997, AstraZeneca restructured its worldwide property damage, business interruption and liability insurance to a three-year combined aggregate basis. AZIC underwrote a master liability policy (MLP) covering "damages on account of (a) Personal Injuries [and] (b) Property Damage" and an excess liability policy (ELP) on identical terms. The ELP was reinsured 100% by the London market, led by CGU and Royal & SunAlliance.

The ELP was a composite policy, covering AstraZeneca and its worldwide subsidiaries based in some 55 countries including the US. One of those subsidiaries was Garst Seed Company (Garst), which was based in Iowa. The ELP also contained a "severability of interest" clause by which AZIC would indemnify all insureds, including Garst, as if a separate policy had been issued to each. Finally, the ELP contained a US "service of suit" clause, which provided that AZIC would submit to the jurisdiction of a US court in the event that AZIC refused to pay any sum claimed by a US insured under the ELP. The ELP contained no express choice of law clause.

The reinsurance policy fully incorporated the terms of the ELP and reinsurers' liability was stated to "commence and expire simultaneously" with that of AZIC. The reinsurance policy contained no follow-the-settlements clause. In a clause entitled "assistance and co-operation", reinsurers agreed to "follow in all respects the fortunes of the Reinsured". Unlike the ELP, the reinsurance policy expressly provided that it would be interpreted and governed by the laws of England, with disputes to be resolved by arbitration in London.

In November 1997, Garst obtained a licence to produce and distribute a genetically modified corn seed called Starlink. From August 1998, the US authorities permitted the use of Starlink for purposes strictly not including human consumption. By September 2000, it became apparent that Starlink had spread into human foods, such as taco shells and corn flakes, and those products were recalled. A number of substantial claims were filed in the US by non-Starlink farmers and consumers totalling approximately $2bn. Garst settled a large number of claims and sought an insurance indemnity from AZIC in the sum of $83m. After properly notifying the reinsurers of the claim, AZIC paid the sum in full without interest. AZIC sought a full indemnity from the reinsurers.

The reinsurers declined to pay the full amount claimed but paid a lower sum, arguing that AZIC's insurance indemnity included heads of loss that were

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irrecoverable under English law. AZIC contended that Iowa law should determine the scope of its recoverability under the ELP and, correspondingly, the reinsurance policy. AZIC sought a dollar-for-dollar indemnity.

## ON TO ARBITRATION

AZIC commenced arbitration proceedings in April 2004 to decide the preliminary issues of: (1) what substantive system of law would determine AZIC's liability to Garst; (2) what substantive law would determine the reinsurers' liability to the AZIC under the reinsurance contract; and (3) what was the effect of the "follow the fortunes" clause.

Importantly, AZIC conceded that in applying English conflicts of laws principles the ELP's governing law was English law. Iowa law became relevant, however, because if AZIC refused the claim, Garst would have sued AZIC in Iowa, invoking the US service of suit clause. For the purposes of AZIC's recovery from the reinsurers, Iowa law should therefore determine the loss under the ELP and the reinsurance policy.

The reinsurers argued that, in light of AZIC's concession that the ELP was subject to English law, even if an Iowa court found that Iowa law governed, this was irrelevant to the dispute. Even if there was a loss under the ELP as claimed, AZIC had to get over a second hurdle of establishing a corresponding liability under the terms of the reinsurance policy, which it failed to do in light of the governing law dispute.

In November 2005, the tribunal published its Partial Award. The majority market arbitrators found that Iowa law determined liability under the ELP and reinsurance policy. Their reasoning was that, although it was clearly not the parties' intention that the ELP would be subject to Iowa law from the outset, by virtue of the US service of suit clause, the relevant substantive law for the purposes of Garst's claim should be Iowa law.

The chairman and third arbitrator, an English QC, dissented. He considered that the majority's decision was flawed because it was founded either on: (1) the ground that cover extended to US insureds was governed by US law – which went behind the concession; or (2) at some stage the governing law was altered by the US service of suit clause – which was not permissible under English law. The reinsurance policy was not itself severable and the majority's award removed from the reinsurers any contractual certainty as to the claims it might receive.

## THE REINSURERS APPEAL

The reinsurers appealed to the UK Commercial Court and the hearing took place in November 2005. The significance of AZIC's concession again formed the heart of the dispute. The reinsurers cited established English authority that a global liability policy cannot be "scissored up" into different laws for different sections. The concession bound the tribunal to apply English conflicts rules and, in the absence of a follow-the-settlements clause in the reinsurance policy, it was legal orthodoxy to apply English law to determine the loss under the ELP and the reinsurance policy. The reinsurers argued that AZIC's case overlooked the nature of reinsurance, as a matter of English law, which is an insurance of the same original risk, not a liability insurance. Even if AZIC might have been found liable by an Iowa court that was not determinative of whether there was cover under the reinsurance. Incorporation of the ELP took place at the outset and "Property Damage" under the ELP carried an English law meaning from that point.

AZIC argued that this was not a conflicts of laws question at all. Instead, it was a matter of English substantive reinsurance law and, having regard to the factual matrix and the back-to-back nature of the reinsurance cover, the Starlink loss could be assessed by a foreign system of law and passed on to the reinsurers.

Justice Cresswell granted the reinsurers' appeal. The majority's conclusion that the parties to the ELP contemplated that coverage afforded to Garst would be determined by US law went behind AZIC's concession, which was properly made. Because the reinsurance policy contained no follow-the-settlements provision, the reinsurers were not liable to pay the reinsured until the amount is ascertained by judgment, award or settlement. AZIC's contention for Iowa law made for a commercially uncertain and unworkable answer to the preliminary issues and Justice Cresswell duly ordered that English law determined coverage under the ELP and the reinsurance policy. The follow the fortunes clause did nothing to alter that decision.

> "From a practical perspective and most importantly, the decision emphasises the importance of a governing law clause and its effect on contractual certainty"

## CONTRACTUAL CERTAINTY

Although this case involved complex conflicts of laws and substantive reinsurance arguments, the decision in fact represents a restatement of established principles. From a practical perspective, the decision emphasises the importance of a governing law clause and its effect on contractual certainty.

Underwriters of group policies might intentionally omit a governing law clause precisely because of the likelihood of claims by foreign insureds and the uncertainty over how that claim might be determined. It may seem trite advice, but such an omission should be avoided. The AstraZeneca decision emphasises that a governing law clause in both the underlying policy and the reinsurance, in partnership with a follow the settlements clause in the reinsurance, eliminates ambiguity, gives effect to the parties' intentions and avoids costly legal disputes. In now its third year since the dispute arose, AZIC has sought leave to appeal to the Court of Appeal. The final determination of the "preliminary issues" may still be some way off yet.

**NOTE**

Lovells acted for CGU International Insurance Plc and others in the case.

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