IN RE AN ARBITRATION BETWEEN

COMMERCIAL LINES INSURANCE

AND

NatCat GMBH

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Advocate General Brief

A. Aggregation issues

1. Under an excess of loss reinsurance treaty, NatCat GmbH (hereinafter "NatCat") provides reinsurance cover for each and every loss in Commercial Line Insurance's (hereinafter "CLI") portfolio in excess of £20,000,000. The treaty contains a choice of law clause in favour of the Principles of Reinsurance Contract Law 2019 as well as an aggregation clause providing that two or more losses covered by the underlying contract are to be treated as one single loss if they are solely and directly caused by "any one event". It is disputed between the parties whether and to what extent individual losses must be aggregated under this aggregation clause.

2. By contrast, it is undisputed between the parties that the aggregation issues are governed by Article 5.2(1) PRICL. According to this provision, "all losses that occur as a direct consequence of the same materialization of a peril reinsured against shall be considered as arising out of one event." Thus, issues of aggregation under Article 5.2(1) PRICL require the following analysis:

1. Determination of the relevant peril, i.e. event.
2. Determination of the number of instances of the materialized peril.
3. Each and every individual loss must be tested to determine whether it can be considered a "direct consequence" of the relevant event.

1. Determination of the relevant event

3. According to Article 5.2(1) PRICL a materialization of a peril reinsured against is to be considered an event. In other words, the peril reinsured against is the event. The relevant peril is the one designated in the reinsurance treaty and not the peril designated in the underlying policies.

4. The excess of loss treaty does not specify the peril reinsured against.[1] It may be that the perils designated in the underlying contracts are incorporated into the reinsurance treaty and thereby become the perils reinsured against. But, it may equally be that the reinsurance treaty provides for all-risk coverage. In such a case, the event is the unnamed peril furthest on the chain of causation that directly provoked the individual losses (see Comment C11 to Article 5.2(1)).

5. As the case study does not indicate whether the reinsurance treaty expressly mentioned the perils reinsured against, it is in the Advocate General's view adequate to proceed this analysis assuming the reinsurance treaty is

[1] At least, there is no information as to this in the case study.

an all-risk contract. Under an all-risk policy, any loss caused by a peril that is not specifically excluded is covered. In other words, any happening that provokes one or multiple losses can be considered an unnamed peril if it is not excluded from the reinsurance coverage. It appears undisputed that the reinsurance treaty does not exclude coverage for losses caused by rainfall. Thus, "heavy rain" may be considered an unnamed peril and thus an event under Article 5.2(1) PRICL.[2]

2. Same materialization (one instance of materialized peril)

6. It is disputed between the parties, whether the "heavy rain" for a seven days period commencing 10 April 2020 can be considered one single or multiple instances of "heavy rain".

7. As the peril of "heavy rain" "is a natural peril, it is expedient to resort to scientific data in order to determine the number of instances the peril has materialized" (see Comment C9 to Article 5.2). In the Advocate General's view, the question whether one or several instances of "heavy rain" occurred cannot be answered without a meteorological study of the happenings between 10 and 17 April 2020 (air pressure, wind, cloud formation, temperature etc.). A meteorological expert study will need to answer the question, whether the "heavy rain" between 10 and 17 April 2020 constituted one or multiple weather phenomena.

8. In application of Article 5.2(1) PRICL only those individual losses resulting from the same instance of "heavy rain" are to be aggregated.

3. Direct consequence

9. Losses are to be aggregated only if they are the direct consequence of the relevant instance of materialized peril reinsured against (see Comment C16 to Article 5.2 PRICL). "[T]he test under the PRICL is whether the causal links between the event and the individual losses are strong enough so as to consider the losses an event's direct consequences" (see Comment C17 to Article 5.2 PRICL).

10. It is undisputed that the unnamed peril of "heavy rain" caused material damage to property and provoked the Government to declare a state of emergency and to order the closure of all motorways for a month. By contrast, it appears to be disputed between the parties that the financial losses stemming from "material damage to insured property" and "financial losses" resulting from the "denial of access consequent on the order of a public authority caused by or arising out of an event in the vicinity of the premises" can be considered a direct consequence of the relevant instance of "heavy rain".

11. "A loss may be considered an event's direct consequence if it can be considered an inevitable result of the relevant aggregating event. A loss may not be considered the direct consequence of the relevant event if an independent, intervening factor has decisively contributed to the occurrence of the loss and thereby broken the chain of causation" (see Comment C18 to Article 5.2 PRICL). "This does, however, not mean that the relevant […] instance of materialized peril […] is necessarily the last happening immediately preceding the occurrence of the loss. Rather, an event may lead to a further happening which then results in losses. If an event inevitably results in a further happening – which may but does not have to be the materialization of another peril reinsured against – then any individual losses which result directly therefrom shall be deemed to have directly arisen from the aggregating event. The reason for this is that the chain of causation between the event and the losses remains unbroken" (Comment C19 to Article 5.2 PRICL).

12. Thus, in the Advocate General's view, the question before Mme Arbitrator is whether the financial losses resulting from the denial of access due to the closure of all motorways can be considered an inevitable result of the relevant instance of "heavy rain"[3] or whether the declaration of emergency and the closure of all motorways must be considered an independent, intervening factor that has decisively contributed to the occurrence of the denial of access losses. In the former case, the denial of access losses would be considered direct consequences of the relevant instance of "heavy rain" in the latter they would not.

13. In the Advocate General's view, the Government hat no choice but to declare a state of emergency and to order the closure of all motorways where roads were washed away and bridges were damaged. The order by a public authority was inevitable. The declaration and order cannot be regarded as an intervening factor independent

[2] The declaration of emergency as well as the order to close all motorways can equally be considered events. However, the event "heavy rain" lies further back in the chain of causation and is thus the relevant event (see Comment C11 to Article 5.2 PRICL) with regard to any losses that can be considered its direct consequences.
[3] The number of instances of "heavy rain" must be determined by a meteorological expert study, see A.2 above.

of the relevant instance of "heavy rain". Consequently, all financial losses sustained by primary insureds due to the closure of motorways where roads and bridges where damaged and not fit for safe traffic can be considered the direct consequence of the relevant instance of "heavy rain".

14. In conclusion, in the Advocate General's view, any individual losses resulting from material damage to insured property and the closure of motorways can be considered direct consequences of the relevant instance of "heavy rain" and must therefore be aggregated.

B. The Refinery (also an aggregation issue)

15. It is further disputed whether the business interruption loss to the oil refinery can be aggregated with the other losses. This is because the oil refinery was first flooded as a consequence of the "heavy rain" and thereafter was further damaged by a entirely unrelated catastrophic fire.

16. It is undisputed that the oil refinery's business was interrupted and that from this business interruption resulted a loss of £5,000,000. In the Advocate General's view, the question before Mme Arbitrator is whether the refinery's business interruption is the direct consequence of the relevant instance of "heavy rain".

17. It appears undisputed that the refinery's buildings and property were not destroyed before 21 April 2020 and that despite being flooded the refinery was operational up until this point in time. Consequently, in the Advocate General's view, the business interruption loss sustained by the refinery was not a direct consequence of the relevant instance of "heavy rain".[4] Therefore, the refinery's loss of £5,000,000 cannot be aggregated with the losses resulting from the relevant instance of "heavy rain".

18. Because the refinery's business interruption loss amounting to £5,000,000 does not pierce the limits of the deductible of £20,000,000 provided for in the reinsurance treaty, CLI has no right to be compensated by NatCat for this loss.

C. The Settlement

19. It is disputed between the parties whether Article 2.4.3 lit. a PRICL is applicable in the present case. According to Article 1.1.3 PRICL, "[t]he parties may exclude the application of or derogate from or vary the effect of any of the provisions of the PRICL." Hence, the parties may exclude the application of Article 2.4.3 lit. a PRICL in that they agree not to include a follow the settlements rule or in that they modify the mechanism of the reinsurer's follow the settlement obligation. In the Advocate General's view, the question before Mme Arbitrator is whether by agreeing that "NatCat indemnifies CLI for losses falling within the terms of the underlying policies and within the terms of the treaty", the parties agreed to exclude or modify the reinsurer's follow the settlements obligation.

20. In *Hill v Mercantiel & General Reinsurance Co Plc* [1996] 1 WLR 1239 (HL), Lord Mustill said that "[t]here are only two rules, both obvious. First, that the reinsurer cannot be held liable unless the loss falls within the cover of the policy reinsured and within the cover of the reinsurance. Second, that the parties are free to agree on ways of proving whether these requirements are satisfied". In follow the settlements clauses, the parties agree on what the reinsured must prove in order that the reinsurer is bound by its settlement in the underlying contract. In other words, a follow the settlements obligation concerns Lord Mustill's second rule and is merely an agreement as to the way of proof.

21. In the Advocate General's view, the parties' agreement that NatCat indemnifies CLI for losses falling within the terms of the underlying policies and within the terms of the treaty does merely restate Lord Mustill's first rule, i.e. that a loss must be covered both by the underlying contract and by the contract of reinsurance. By contrast, this is not an agreement as to how the reinsured must prove that the loss is covered under the respective contracts. Hence, the parties' contract does not contain any language as to the way the reinsured must prove that a loss is covered under the respective contracts (Lord Mustill's second rule/follow the settlements obligation). Therefore, there is no language in the reinsurance treaty that excludes or modifies Article 2.4.3 lit. a PRICL and Article 2.4.3 lit. a PRICL is applicable as destined by the PRICL.

22. Article 2.4.3 lit. a PRICL provides that the reinsurer shall follow the settlements of the reinsured if two provisos are met (see Comment C3 to Article 2.4.3 PRICL, my emphasis):

[4] In case the refinery's flood damage contributed to the final destruction of the buildings and property, the catastrophic fire must be considered an independent, intervening factor breaking the chain of causation between the relevant instance of "heavy rain" and the business interruption losses.

- First, the claim as settled by the reinsured is arguably covered by the underlying contract and,

- second, the claim as recognized is within the coverage of the contract of reinsurance as a matter of law.

In this provision, the PRICL provide for a follow the settlements rule in the style of the well known full reinsuring clause as interpreted in *The Insurance Company of Africa v Scor (UK) Reinsurance Co Ltd* [1985] 1 Lloyd's Rep 312 (CA). Yet, even though modelled on the case law of the full reinsuring clause, the follow the settlements rule of Article 2.4.3 lit. a PRICL merits its autonomous interpretation and the English Court of Appeal's judgment is not authoritative for its interpretation.

23. In the case at hand, it appears to be undisputed that CLI settled all its claims for 80% of their value so that some policyholder will inevitably have been overcompensated whereas others have been undercompensated.

24. It is the Advocate General's view that a mass settlement of claims for 80% of their value may be a commercially reasonable settlement achieving a superior financial outcome that benefitted both CLI and NatCat due to substantial savings on litigation costs and risks. "[I]t cannot be said with positive assurance that […] no reasonable person would support the amounts paid in settlement" wherefore the settlements should be considered sufficiently reasonable in amount and terms (See Comment C4 to Article 2.4.3 PRICL). In the Advoicate General's view, CLI meets the first proviso.

25. Turning to the second proviso, CLI must prove that the losses as recognized in the settlements are covered by the contract of reinsurance as a matter of law. CLI admits that it has overcompensated some policyholders. Whenever CLI recognized claims that would not have been covered by the underlying contract, these claims will not as a matter of law be covered by the contract of reinsurance. Therefore, at least with regard to some claims, CLI does not meet the second proviso. For these claims, NatCat is not bound to follow CLI's settlements.

26. It appears to be undisputed that in other cases, CLI has undercompensated its policyholders. In these cases, CLI's settlements remained within the underlying contracts' covers. As a matter of law, such losses have to be considered within the coverage of the contract of reinsurance so that NatCat is bound to follow these settlements.

27. In the Advocate General's view and taking into consideration (as an inspiration) *Equitas Ltd v R&Q Reinsurance Co Ltd* [2009] 2 CLC 706 (Com), the follow the settlement rule of Article 2.4.3 lit. a PRICL does not legislate for the evidence required to prove losses of properly settled claims. CLI is entitled to seek to discharge the legal burden resting upon it – of proving that in the overall settlement it did not pay more than it would have paid had it paid 100% of all the claims that were in fact covered by the underlying contracts – by the use of the best evidence it has available. Should such evidence suffice to discharge that legal burden, CLI does not need to re-examine each and every settlement transaction within the mass settlement. It is not excluded that CLI is able to discharge that legal burden using an actuarial model. Therefore, in the Advocate General's view, even though Article 2.4.3 lit. a PRICL requires that CLI proves that losses as recognized in the underlying settlements are within the contracts of reinsurance, with regard to mass settlements CLI may be successful in proving this using an actuarial model.

D. Conclusion

28. In the Advocate General's view, the questions before Mme Arbitrator should be answered in the following:

1 – An instance of "heavy rain" is the relevant event.

2 – Only a scientific meteorological study may conclude the number of instances of "heavy rain" and thus of events during the period between 10 and 17 April 2020.

3 - Any individual losses resulting from material damage to insured property and the closure of motorways can be considered direct consequences of the relevant instance (for the number of instance, cf. 2-) of "heavy rain" and must therefore be aggregated.

4 – The relevant instance of "heavy rain" did not cause the refinery's business interruption. Therefore, the refinery's BI loss is not to be aggregated with the other losses. Moreover, the refinery's BI loss is not covered under the treaty as it does not reach the limit of the agreed deductible.

5 – Article 2.4.3 lit. a PRICL is applicable. Moreover, CLI must prove that its settlement claims as recognized are within the contract of reinsurance. NatCat is not bound to follow CLI's settlements where CLI is unable to prove this. However, CLI may discharge its burden of proof by using an actuarial model instead of re-examining each and every settlement.

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