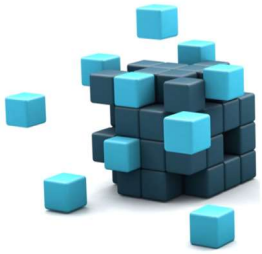
PRICL Mock Arbitration



Project Group on
Principles of Reinsurance Contract Law
(PRICL Project Group)

Reinsurance Working Party
Dispute Resolution Working Party

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TRIBUNALS' AWARD

Application of PRICL

Art 1.1.1 of the PRICL states that they apply to contracts of reinsurance where the parties have agreed that their contract shall be governed by them.

The guidance provided by the report published at https://www.ius.uzh.ch/dam/jcr:c5e36159-2cbc-4686-83ce-1067bc4704a3/PRICL_1.0_2019.pdf states that the PRICL have been drafted as "soft law", rather than as a model law requiring implementing national, international or supranational legislation. Rather than being imposed on parties to a contract, the soft law nature of the PRICL means that they will apply only when chosen by parties as the law governing their contract.[1]

In the problem scenario we discussed today the parties have agreed that their contract be governed by the PRICL.

The issues in dispute:

1) The definition of "event" and the correct identification of the relevant "event" in the case
2) Whether the reinsurers were obliged to follow the reinsured's settlement
3) Whether the reinsured has breached its duty of utmost good faith
4) Whether the reinsurance provides an "all risks" cover and therefore the claims made following the rainfall and the motorways closure can be merged

Event

Under Art 5.2. of the PRICL the following guidance is provided:

C6: Under the PRICL, an event is considered to be an instance of materialised peril reinsured against.

The key words here are "an instance of materialised peril reinsured against" and the issue at the heart of the matter is whether the rainfall or the flood in the case scenario falls into this category?

[1] https://www.ius.uzh.ch/dam/jcr:c5e36159-2cbc-4686-83ce-1067bc4704a3/PRICL_1.0_2019.pdf Introduction to PRICL, [4]

Under the PRICL Art 5.2.
C7 provides: In the context of insurance and reinsurance, a peril or risk is the uncertainty arising from the possible occurrence of a given event that may cause injury, loss or destruction (see Glossary of Insurance and Risk Management Terms, International Risk Management Institute Inc under the search term "risk").

A rainfall itself does not necessarily cause any loss or destruction. Insurance contracts generally list perils that are implicitly contain some sort of danger of causing harm. Earthquake, fire, explosion, and flood are some of those words that implicitly express some sort of danger that they bring about. Additionally, insurance policies generally refer to the word "flood" rather than "rainfall" to express a peril caused by rain. In this regard it is the flood rather than the rainfall in the case scenario that is to be regarded as the event to be taken into account in aggregating the losses reinsured.

A further support for the above ruling can be seen in "C8" under the PRICL Art 5.2. that "Reinsurance policies regularly designate the perils reinsured against. Depending on the type of reinsurance involved, such perils may include illness, fire, windstorm, tempest, flood, earthquake, hail, terrorist attack, theft, etc." Noticeably, the word flood is used here, but not rainfall. Similarly, "C9" states: "For natural perils, such as windstorm, tempest, flood, earthquake, hail or illness, it is expedient to resort to scientific data in order to determine the number of instances a peril has materialised."

It is understood that the PRICL is expected to be read together with the UNIDROIT Principles of International Commercial Contracts 2016 ("PICC").

PICC Art 4.1 provides:
(Intention of the parties)
(1) A contract shall be interpreted according to the common intention of the parties.

(2) If such an intention cannot be established, the contract shall be interpreted according to the meaning that reasonable persons of the same kind as the parties would give to it in the same circumstances.

Under Art 4.2. of PICC
(Interpretation of statements and other conduct)

(1) The statements and other conduct of a party shall be interpreted according to that party's intention if the other party knew or could not have been unaware of that intention.

(2) If the preceding paragraph is not applicable, such statements and other conduct shall be interpreted according to the meaning that a reasonable person of the same kind as the other party would give to it in the same circumstances.

Furthermore,
ARTICLE 4.3 explains "Relevant circumstances" that:
In applying Articles 4.1 and 4.2, regard shall be had to all the circumstances, including
(a) preliminary negotiations between the parties;
(b) practices which the parties have established between themselves;
(c) the conduct of the parties subsequent to the conclusion of the contract;
(d) the nature and purpose of the contract;
(e) the meaning commonly given to terms and expressions in the trade concerned;
(f) usages.

Moreover, Art 1.1.4 of the PRICL refers to "Usages and practices" that

(1) The Parties shall be bound by any usage to which they have agreed and by any practices which they have established between themselves.
(2) A trade usage which is regularly known to and observed by parties to a reinsurance contract shall be taken into account when interpreting the terms of the contract.

In the light of the above, the tribunal is of the view that a reasonable person would regard the "flood" in the case scenario as the relevant event but not the rainfall.

Follow the settlements

The references above to the PICC and the PRICL with respect to the construction of contracts and the meaning of the contractual clauses are also relevant to determine the applicability of Art 2.4.3 of the PRICL which provides:

"To the extent a loss is covered by the contract of reinsurance, the reinsurer shall

(a)follow the settlements of the reinsured if the losses are arguably within the cover of the primary insurance contract;

(b)follow the fortunes of the reinsured."

Explanations provided as to this article of the PRICL in the report as referred to above are:

C3: The reinsurer's duty to follow the reinsured's settlements is subject to two requirements: First, the claim as settled by the reinsured is arguably covered by the underlying contract and, second, the claim as recognised is within the coverage of the contract of reinsurance as a matter of law.

C.4: "Arguably covered" requires that the settlement of claims made by the reinsured is not collusive, fraudulent, deceptive, grossly negligent or reckless, clearly outside of coverage, or beyond the amount of limits set forth in the agreement.

C6: The follow-the-fortunes principle covers developments beyond the reinsured's control and this includes coverage judgments against the reinsured.

The "follow the fortunes" issue was not raised by the parties and therefore is not relevant.

The "follow the settlements" principle goes back to the early twentieth century so far as English law is concerned. One of the fundamental principles of reinsurance law, as a reflection of the principle of indemnity, is that the reinsured has to establish

- its liability to the insured person and that
- the loss paid to that person also falls within the cover provided by the reinsurer.

An agreement to "follow the reinsured's settlements" refers to the proof of the reinsured's liability under the original insurance contract. Although controversial because of some recent case law developments which are not relevant to the dispute here, basically, the reinsured can prove liability under the original insurance by either a judgment or an arbitration award in favour of the assured.

However, in some cases, the reinsured and the assured may settle the assured's claim without having a judgment or an arbitration award that has determined the reinsured's liability. By agreeing to "follow the settlements" the reinsurer is regarded to have expressed "when you decide to settle a claim by the insured person, I will follow such a settlement so long as the settlement is bona fide and businesslike and the loss is covered by the reinsurance contract". The guidance with respect to the reading of the follow the settlements clause can be found in *Insurance Co of Africa* v *Scor (UK) Reinsurance* [1985] 1 Lloyd's Rep 312. The tribunal is aware of the fact that PRICL does not implement any of the national laws in this respect, however, the PRICL aims to set international reinsurance principles and the reading of the follow the settlements by the *Scor* case is an internationally accepted principle of reinsurance law.

In the case scenario a dispute between the parties arose because of the policy wording which expressed that "NatCat would indemnify CLI for losses falling within the terms of the underlying policies and within the terms of the treaty."

Whether or not the reinsurers were obliged to follow the reinsured's settlement depends on the function to be given to this wording in the reinsurance contract.

There is no doubt that the incorporation of the PRICL in the contract, in principle, included Art 2.4.3. However, the express wording of the reinsurance contract stated above is in conflict with Art 2.4.3.

Art 2.4.3 states that the reinsurer will follow the reinsured's settlement but the express clause states that the reinsurers will do so only if the claim falls within the terms of the underlying policies.

The question is how are these two conflicting provisions of the reinsurance contract will be read together?.

So far as the proof of liability under the original insurance contract is concerned, the reinsurers say, by virtue of the follow the settlements clause, that "if your settlement is bona fide and businesslike, I will follow so". However, the express clause stated above requires proof of actual liability under the original insurance. This is so because of the established and internationally accepted reading of such clauses in the reinsurance contracts: See for instance a case decided by the courts of New Zealand: *New Zealand Local Government Insurance Corporation LTD v R+V Versicherung AG* [2013] NZHC 690 and a case decided by the English courts: *Commercial Union Assurance Co v NRG Victory Reinsurance Ltd* [1998] Lloyd's Rep. I.R. 421

The express clause in the reinsurance contract in the case scenario qualifies the follow the settlements clause that is included in the same reinsurance contract to the effect that proof of actual liability is required for the insurer to claim against the reinsurers.

Further matters that support the tribunal's reasoning are that

Art 1.1.3 of the PRICL provides: The parties may exclude the application of or derogate from or vary the effect of any of the provisions of the PRICL.

C5 under Art 1.1.3 states : The non-mandatory nature of the PRICL is justified, because there are no policy reasons for restricting the parties' freedom of contract in reinsurance transactions. Parties negotiate the contract on equal footing and, thus, there is no room for mandatory rules in favor of one of them.

C9: Any contractual exclusion or modification of the PRICL may be either express or implied. As has been stated with regard to the equivalent rule in Article 1.5 PICC Comment 2,

> [t]here is an implied exclusion or modification when the parties expressly agree on contract terms which are inconsistent with provisions of the Principles and it is in this context irrelevant whether the terms in question have been negotiated individually or form part of standard terms incorporated by the parties in their contract.

C10. The same applies to an implied exclusion or modification of the PRICL.

The tribunal is of the view that the parties modified Art 2.4.3 of the PRICL by the express clause referred to above so far as the follow the settlements principle is concerned.

In this regard the references to the PICC that have been made above in relation to the identification of the relevant "event" are also applicable here.

Art 1.1.4 C6 states: As with Article 4.3(f) PICC, under Article 1.1.4 paragraph (2) a court or arbitral tribunal, as the case may be, will have a considerable amount of discretion as to the extent to which it should draw upon particular usages in spite of the parties' choice in favor of the PRICL.

If necessary, therefore, the tribunal is ready to use the discretion granted under Art 1.1.4 to rule that the express clause in the reinsurance contract, as required by the internationally accepted reading of it, amends the PRICL Art 2.4.3.

The duty of utmost good faith

The meaning of the phrase "utmost good faith" is explained by the PRICL Art 2.1.2
"The parties owe one another the duty of utmost good faith. "Utmost Good Faith" means honesty and transparency as well as fairly taking into account the interests of the other party."

Under Art 2.1.2 paragraph 4 states: "The touchstone of the concept of utmost good faith is honest and reasonable conduct in the context of the situation".

The issue here is whether the reinsurers proved that the reinsured breached the relevant duty ? How would a reinsurer satisfy such a burden of proof? It can be met only where the reinsurer proves that the reinsured acted in bad faith. The tribunal is of the view that the reinsurer did not meet this burden of proof. The tribunal rejects the reinsurer's submission that whenever a reinsured attempts to maximise its recovery, the reinsured acts in bad faith. This is an overstretched reading of acting in bad faith.

Event-based aggregation and merging separate causes of the loss

Art 5.2 of the PRICL states:

(1) Where the parties agree on an event-based aggregation in a contract reinsuring first-party insurance policies, 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

Further guidance is provided as follows:
C4: There must be a causal link between the relevant event on the one hand and any losses to be aggregated on the other hand. If the parties agree on an aggregation per event, any losses that can be considered a direct consequence of an event are aggregated. This involves a two-step analysis.

C5: First, the relevant event for the aggregation of losses is to be determined. Depending on whether first-party (a) or third-party (b) insurance policies are reinsured, the process of
determining the relevant event differs. Secondly, each loss must be tested to determine whether it can be considered a "direct consequence" of this event (c).

C11: If a contract provides for all-risk coverage, the materialisation of any unnamed peril that triggers the contract is to be considered a relevant event for the purpose of aggregating losses under paragraph (1). Similarly, in case a contract covers both named and unnamed perils, the materialisation of any unnamed peril may constitute the relevant event within the meaning of paragraph (1). In such cases, any losses that directly result from the event furthest on the chain of causation may be aggregated under paragraph (1).

Illustration Reinsured A takes out all-risk property reinsurance. An earthquake occurs and causes losses 1 and 2. At the same time, the earthquake triggers a tsunami which causes losses 3 and 4. As no peril is named in the contract, the materialization of any peril is to be considered an event under paragraph (1). Consequently, both the earthquake and the tsunami may constitute events. As the earthquake is the event furthest away from losses 3 and 4, it is the relevant event for the purpose of aggregation. Consequently, losses 1 and 2 are to be aggregated with losses 3 and 4.

The main question here is whether the reinsurance contract provided an "all risks" cover. Neither the wording of the original insurance nor the reinsurance does clearly state whether the cover is provided on an all risks terms. Because the case scenario does not expressly state otherwise, the tribunal accepts the reinsured's submission that the reinsurance contract should be regarded as providing an all risks cover and the merger expressed under C11 above is potentially applicable.

However, the issue is, whether a localised or a national merger is acceptable.

The CLI's policy provides:

"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."

The key word here is "vicinity". The reinsured submitted that the word "vicinity" should be read broadly that it meant "the whole region" that has been affected by the peril insured against. The tribunal is not aware of any internationally commonly accepted meaning of "vicinity". The most recent guidance on the meaning of this word was provided by the High court of England and Wales in, *Financial Conduct Authority v Arch Insurance and Others* [2020] EWHC 2448 (Comm), the case that tested 21 different policy wordings in relation to the COVID-19 related business interruption insurance claims. However, it is doubtful how beneficial that guidance here can be as the Court read the word vicinity differently in different contexts. Accordingly, one way of reading the word is as "a near area or neighbourhood" whereas another was of reading as "embrace the whole country.".

The tribunal considers the effect of the wordings of "consequent on", "caused by or arising out of" an event in the vicinity of the premises. The words in inverted commas indicate a narrow reading of the word vicinity because it requires denial of access (insured peril) occurring as a result of an event in the vicinity. The event should take place in the vicinity, ie, in the neighbourhood. Since Art 2.4.3 does not apply here, only a settlement with the assured will not suffice a successful claim against the reinsurer. The tribunal hopes that the reinsured revise the amount claimed against the reinsurers by localising and accordingly adjusting the amount settled and the reinsurers agree to follow that settlement (perhaps) in order to maintain its relationship with the reinsured. Otherwise, since the reinsured already finalised the assured's claim, it would not be able to deny coverage against the assured (which

would then lead to a legal action by the assured to prove reinsured's liability under the insurance contract). Consequently, the reinsured will have to give up his claim against the reinsurers because of the proof of liability issue. The matter lies in the hands of the reinsurers.

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