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Formulation de Principes relatifs aux contrats de réassurance

(préparé par le Secrétariat)

<i>Sommaire</i>	<i>Rapport final du projet</i>
<i>Action demandée</i>	<i>Le Conseil de Direction est invité à prendre note de la version finalisée des dispositions et des commentaires des Principes relatifs aux contrats de réassurance préparée par le Groupe de travail sur les PRICL, à exprimer sa satisfaction pour l'utilisation des Principes d'UNIDROIT relatifs aux contrats du commerce international comme modèle et comme règles du droit général des contrats et à autoriser le Secrétariat inclure une référence au texte des PRICL sur le site Internet d'UNIDROIT une fois leur publication terminée.</i>
<i>Mandat</i>	<i>Programme de travail 2017-2019</i>
<i>Degré de priorité</i>	<i>Bas</i>
<i>Documents connexes</i>	<i>UNIDROIT 2019 – C.D. (98) 2; C.D. (98) 14</i>

I. HISTORIQUE ET ETAT ACTUEL DU PROJET

1. En juillet 2015, le Secrétariat a été contacté par un groupe de chercheurs et de juristes praticiens dirigé par les Professeurs Anton K. Schnyder et Helmut Heiss (Université de Zürich, en qualité de "Chef de file"), Martin Schauer (Université de Vienne) et Manfred Wandt (Université de Francfort), qui ont examiné la faisabilité de formuler des "Principes du droit des contrats de réassurance" (PRICL). Cette initiative s'inspire du Groupe chargé de la "Redéfinition du droit régissant le contrat d'assurance européen", qui a débouché sur la publication des "Principes du droit européen du contrat d'assurance" (PDECA)¹. Ce projet a pour objectif de formuler une "redéfinition" du droit

¹ Principes du droit européen du contrat d'assurance, édité par le Groupe chargé de la "Redéfinition du droit régissant le contrat d'assurance européen", établi par Fritz Reichert-Facilides †, Président: Helmut Heiss, *Sellier European Law Publishers* (octobre 2009).

de la réassurance existant, qui est largement ancré dans la coutume et l'usage international, mais fait rarement l'objet d'une législation.

2. Les responsables du projet ont exprimé l'avis que les principes proposés supposent l'existence préalable de règles adéquates du droit général des contrats. Plutôt que d'essayer de recréer ces règles, les nouveaux principes proposés devraient être rédigés de manière à assurer une cohérence entre les PRICL et les Principes d'UNIDROIT relatifs aux contrats du commerce international (les Principes d'UNIDROIT) et, en conséquence UNIDROIT a été invité à prêter sa collaboration.

3. Le Conseil de Direction a décidé de recommander à l'Assemblée Générale d'insérer ce sujet au Programme de travail pour la période triennale 2017-2019, et a proposé de lui attribuer une priorité basse. L'Assemblée Générale a approuvé la recommandation du Conseil de Direction à sa 75^{ème} session le 1^{er} décembre 2016.

4. Le projet a été entièrement financé grâce au soutien du Fonds national suisse de la recherche scientifique, de la Fondation allemande pour la recherche et du Fonds autrichien pour la promotion de la recherche. Outre les chefs de projet, l'équipe de recherche comprend des représentants renommés de l'Afrique du Sud, de l'Allemagne, de la Belgique, du Brésil, de la Chine, des Etats-Unis d'Amérique, de la France, de la Grande-Bretagne, de l'Italie, du Japon et de Singapour. En outre, deux groupes consultatifs constitués de représentants des marchés mondiaux des assurances et de la réassurance ont conseillé l'équipe de recherche.

5. Depuis le début du projet, UNIDROIT a participé activement aux différents ateliers (Zürich , 27-30 janvier 2016; Vienne, 12-15 octobre 2016; Francfort, 8-12 mars 2017; Zürich, 28 juin-1^{er} juillet 2017), principalement en vue d'assurer la cohérence entre les PRICL et les Principes d'UNIDROIT, sur le fond comme pour le cadre de référence général, et de fournir une interprétation et des exemples de la mise en œuvre pratique des UPICC.

6. Les 16 et 17 janvier 2018, à Vienne, UNIDROIT a participé au 5^{ème} Atelier principalement en vue d'assurer la cohérence entre les dispositions concernant les moyens en cas d'inexécution et les Principes d'UNIDROIT, et de fournir une interprétation des dispositions correspondantes des Principes d'UNIDROIT. Le 6^{ème} Atelier du Projet s'est tenu à Francfort du 6 au 8 juin avec la participation d'UNIDROIT et depuis lors, le Groupe de travail a travaillé à un projet consolidé qui est présenté à la présente session du Conseil de Direction (Rome, 8-10 mai 2019).

7. Les PRICL se présentent comme un ensemble de règles non contraignantes que les parties peuvent soit choisir comme loi régissant leur contrat, soit incorporer dans leur accord. A cet égard, les PRICL s'inspirent du Préambule des Principes d'UNIDROIT (voir l'article 1.1.1). Toutefois, les PRICL contiennent également une disposition (Art. 1.1.2) traitant des lacunes externes, selon laquelle "les questions non réglées par les PRICL seront réglées conformément aux Principes d'UNIDROIT relatifs aux contrats du commerce international 2016". Afin de faciliter le choix des PRICL par les parties, les rédacteurs ont, en outre, inséré un modèle de clause type de choix de la loi qui dispose "[L]e présent contrat est régi par les Principes relatifs aux contrats de réassurance (2019)" et deux modèles de clauses qui complètent la précédente pour combler les lacunes, selon lesquelles " a) Le présent contrat est régi par les Principes du droit des contrats de réassurance (2019) *et, en ce qui concerne les questions qui ne sont couvertes ni par ces Principes ni par les Principes d'UNIDROIT relatifs aux contrats du commerce international (2016), par les principes généralement admis du droit commercial international*" et " b) Le présent contrat est régi par les Principes du droit des contrats de réassurance (2019) *et, en ce qui concerne les questions qui ne sont couvertes ni par ces Principes ni par les Principes d'UNIDROIT relatifs aux contrats du commerce international (2016), par le droit de [l'Etat X].*"

8. Les PRICL sont composés des parties suivantes: Chapitre I: Partie générale; Chapitre II: Obligations; Chapitre III: Moyens; Chapitre IV: Agrégat; Chapitre V: Allocation. La relation entre le projet des PRICL et les Principes d'UNIDROIT est expressément traitée et expliquée aux points pertinents dans les commentaires aux articles. Ces commentaires se réfèrent aux dispositions des Principes d'UNIDROIT qui ont influencé celles des PRICL. Ils font également référence aux règles du

droit général des contrats contenues dans les Principes d'UNIDROIT qui ne sont pas reproduites dans les PRICL mais qui régiront le contrat si les PRICL sont choisis comme droit applicable. L' *Introduction* aux PRICL figurant à l'Annexe I du présent document (pages 1 à 8) contient une explication plus détaillée de la relation entre les PRICL et les Principes d'UNIDROIT.

9. Les PRICL feront l'objet d'une réunion spéciale qui se tiendra le vendredi 10 mai à 11h30 pendant la présente session du Conseil de Direction. Elle comprendra les points suivants: *Présentation des Principes en matière de contrats réassurance et de leur relation avec les Principes d'UNIDROIT relatifs aux contrats du commerce international* par le Professeur Helmut Heiss (Université de Zurich); *"Obligations" et "Moyens" dans les Principes du droit des contrats de réassurance au regard des Principes d'UNIDROIT relatifs aux contrats du commerce international* par la Professeure Diana Cerini (Université Milano Bicocca); *Point de vue d'un assureur direct* par Monsieur Lari Kuitunen (If P&C Insurance); et *Point de vue d'un réassureur* par M. Eberhard Witthoff (Munich Re Group). L'ordre du jour de la session figure en Annexe II.

10. Le 22 décembre 2018, le Secrétariat a été informé que le Groupe de travail avait reçu un financement qui soutiendrait le projet pour une autre période triennale (1^{er} juillet 2019 - 30 juin 2022), étant entendu que le Groupe de travail compléterait les PRICL en ajoutant les chapitres suivants: Chapitre VI: Couverture adossée; Chapitre VII: Clauses de responsabilité extra contractuelle; Chapitre VIII: Echéance de contrat et recapture; Chapitre IX: Délais de prescription. En raison des liens entre certains de ces sujets et les Principes d'UNIDROIT, et de l'opportunité que cette deuxième partie des PRICL continue de faire référence aux Principes d'UNIDROIT à la fois dans la clause générale de conflit de lois et dans les règles et commentaires spécifiques des dispositions, le Groupe de travail des PRICL a demandé à UNIDROIT de poursuivre sa collaboration dans les mêmes conditions que précédemment. Voir les propositions pour le Programme de travail 2020-2022, C.D. (98) 14 rév, 49-52.

II. ACTION DEMANDEE

11. Le Secrétariat d'UNIDROIT souhaite inviter le Conseil de Direction à 1) prendre note de la version finalisée des dispositions et des commentaires des Principes du droit des contrats de réassurance (PRICL) - Première partie, préparée par le Groupe de travail des PRICL et jointe en Annexe I au présent document- , 2) à recommander l'utilisation des Principes d'UNIDROIT relatifs aux contrats du commerce international comme modèle et comme règles de droit général des contrats et 3) à autoriser le Secrétariat à inclure une référence au texte des PRICL sur le site Internet d'UNIDROIT une fois leur publication terminée.

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

Zurich, Vienna, Frankfurt am Main
<https://www.ius.uzh.ch/de/research/projects/pricl.html>

in cooperation with the

**International Institute for the Unification of Private Law
(UNIDROIT)**

Rome
<https://www.unidroit.org/>

**PRINCIPLES OF
REINSURANCE
CONTRACT LAW
(PRICL)**

2019

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Foreword

This volume contains the “Principles of Reinsurance Contract Law (PRICL) 2019”. The Principles were produced by the Project Group on Principles of Reinsurance Contract Law (PRICL) in cooperation with the International Institute for the Unification of Private Law (UNIDROIT). The PRICL provide reinsurance specific rules on contract law in areas where reinsurance practitioners felt that there was a need to improve legal certainty. At the same time, the PRICL incorporate uniform rules on general contract law by virtue of a reference to the UNIDROIT Principles of International Commercial Contracts (PICC 2016).

The editors wish to express their gratitude to all of the participants in the project. Many thanks go to the members of the Principles Drafting Committee (PDC), especially those who acted as rapporteurs. We are immensely grateful to the International Institute for the Unification of Private Law (UNIDROIT) for allowing the Project Group to incorporate by reference its PICC 2016 and for participating in the Project Group’s workshops. We sincerely thank the members of the Advisory Groups and their coordinator, Christian Felderer, as well as our Special Advisors for their indispensable insights into market practice, without which this project could not have been pursued. Not the least, we would like to thank the members of staff for the high quality of services provided to the project leaders and the entire Project Group.

The Project Group is extremely grateful for the essential financial support covering three years of work provided by the *Schweizerische Nationalfonds zur Förderung der wissenschaftlichen Forschung (SNF)*/Swiss National Science Foundation (SNSF) (lead agency), the *Deutsche Forschungsgemeinschaft*/German Research Foundation (DFG) and the *Österreichische Fonds zur Förderung der wissenschaftlichen Forschung*/Austrian Science Fund (FWF).

In addition, the Group is indebted to many institutions, not least to reinsurance and insurance companies, broker firms and law firms, for their support in providing experts to participate in the Project Group’s workshops.

Zurich, Vienna, Frankfurt am Main

May 2019

*Helmut Heiss
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Final Draft - subject to linguistic amendments

Introduction

1. The Project Group

The Project Group on Principles of Reinsurance Contract Law (PRICL) was set up as a joint venture of the Universities of Zurich, Frankfurt am Main and Vienna in early 2016 (for more detailed information, see <<https://www.ius.uzh.ch/de/research/projects/pricl.html>>, last accessed on 1 April 2019). Its funding was secured through research grants provided by the Swiss National Science Foundation (SNSF), the German Research Foundation (DFG) and the Austrian Science Fund (FWF). The Project Group is made up of several panels: The Principles Drafting Committee (PDC), Advisory Groups and Special Advisors.

The PDC drafts Rules on reinsurance contract law as well as accompanying Comments and Illustrations. It is comprised of professors from several countries around the world (Austria, Belgium, Brazil, France, Germany, Italy, Japan, Singapore, South Africa, Switzerland, the UK and the USA; see <<https://www.ius.uzh.ch/de/research/projects/pricl/whoweare/draftingcommittee.html>>, last accessed on 1 April 2019). The Advisory Groups, on the other hand, are made up of representatives from primary insurance companies see (<<https://www.ius.uzh.ch/de/research/projects/pricl/whoweare/agi.html>>, last accessed on 1 April 2019), reinsurance companies and reinsurance brokers (see <<https://www.ius.uzh.ch/de/research/projects/pricl/whoweare/agr.html>>, last accessed on 1 April 2019). They expound the living law of reinsurance, provide any practical information required for the project and comment on the drafts of the Principles based on their experience in practice. Last but not least, Special Advisors provide their expertise in relation to specific questions, such as arbitration issues or the effect of internationally mandatory provisions on the application of transnational principles (see <<https://www.ius.uzh.ch/de/research/projects/pricl/whoweare/specialadvisors.html>>, last accessed on 1 April 2019).

The overall aims of the PRICL Project Group are similar to those of the Restatements of the American Law Institute (ALI) in the US. The ALI was founded “to promote the clarification and simplification of the law and its better adaptation to social needs, to secure the better administration of justice, and to encourage and carry on scholarly and scientific legal work” (<<https://www.ali.org/about-ali/how-institute-works/>>, last accessed on 1 April 2019). The same may be said of the PRICL, with the difference that they operate at a transnational level (see HEISS (2011) 803 et seq. with regard to transnational insurance law in general) and are restricted to reinsurance contract law (similarly, the Introduction to the 1994 edition of the UNIDROIT Principles of International Commercial Contracts mentions that the UNIDROIT initiative is aimed at elaborating an international restatement of general principles of contract law).

2. Cooperation partner: UNIDROIT

The Project Group’s work is carried out in cooperation with the International Institute for the Unification of Private Law (UNIDROIT) in Rome which included the PRICL project in its working program for the period 2017-2019 (announced on the UNIDROIT

website: <<https://www.unidroit.org/work-in-progress/reinsurance-contracts>>, last accessed on 1 April 2019). Founded in 1926 as an organization of the League of Nations, upon its dissolution UNIDROIT continued operating as an independent intergovernmental organization (see <<https://www.unidroit.org/about-unidroit/overview>>, last accessed on 1 April 2019; VOGENAUER 14). UNIDROIT currently has 63 Member States. Notably, because of its status as an intergovernmental organization, only states can become members (see <<https://www.unidroit.org/about-unidroit/membership>>, last accessed on 1 April 2019; VOGENAUER 14).

The Institute's tasks and goals are described on its website as follows: "Its purpose is to study needs and methods for modernising, harmonising and co-ordinating private and in particular commercial law as between States and groups of States and to formulate uniform law instruments, principles and rules to achieve those objectives" (see <<https://www.unidroit.org/about-unidroit/overview>>, last accessed on 1 April 2019). In addition to producing instruments containing uniform international law, UNIDROIT is therefore also concerned with developing transnational principles governing commercial law (soft law) comparable to the PRICL (cf. VOGENAUER 11). Incidentally, efforts were made within UNIDROIT to initiate work towards a standardization of reinsurance law in 1935/36. The project was, however, left with no chance of realization due to the circumstances at the time.

3. **The purpose of the project: Providing reinsurance markets with uniform rules on reinsurance contract law**
 - a. **Status quo: National perceptions of (transnational) reinsurance contract law**

While reinsurance is an international business, reinsurance law is national law. The national law applicable governs key aspects of the contract, such as its conclusion, its validity, its interpretation or the existence of implied terms (this importance of the law applicable in relation to the interpretation of reinsurance contracts was pointed out by GERATHEWOHL 489; see also NEBEL 60). The legal rules applicable, more generally, also determine the questions of whether and, if so, which reinsurance customs must be observed by the contracting parties (cf. HOFFMAN with regard to US law; CLYDE & CO 15.25 et seqq. with regard to English law; CANNAWURF & SCHWEPCKE § 8, 65 et seqq. with regard to German law; NEBEL 58; ONDO 41, footnote 14, both with regard to Swiss law.). As an example, take a reinsurance contract without a "follow-the-settlements clause" and the question of whether the reinsurer is nevertheless under a duty to follow the settlement of its reinsured. On the basis of a corresponding, purportedly international reinsurance custom (which has, however, "never been shown to exist" according to HOFFMAN 78; for reinsurance customs in general, see e.g. MELLO 87 et seqq. with examples), this duty is accepted in German legal commentary (for greater detail, see e.g. LOOSCHELDERS § 209 VVG, 62; CANNAWURF & SCHWEPCKE § 8, 76 et seqq.; GERATHEWOHL 473 et seqq.; QUINTO 10; cf. also REYMOND 403, discussing the Judgment of the Swiss Federal Supreme Court, *BGE 107 II 196*) and it will be considered an implied term by some US American courts (see e.g. *International Surplus Ins v Underwriters at Lloyd*, 868 F Supp 917, 920, applying Ohio law; *Aetna Casualty and Surety Co v Home Insurance Co*, 882 F Supp 1328 (SDNY 1995) 1350, applying New York law; according to HOFFMAN 78, these cases erroneously suggested that the follow-the-settlements clause was implied in fact by a reinsurance usage that has never been shown to exist). However, not all US American courts will recognize the duty (cf.

CANNAWURF & SCHWEPCKE § 8, 83; STENBERG § 12, 55) and English courts will, in fact, reject it in the absence of an agreement in the contract (*Commercial Union Assurance Company plc and Others v NRG Victory Reinsurance Ltd* [1998] CLC 920, 935; GEIGER 117; O'NEILL & WOLONIECKI 5-013).

The fact that some jurisdictions correspond with each other in recognizing such an implied term does not necessarily mean that the content of the duty to follow the settlements will be construed identically (HOFFMAN 74 et seq.; cf. NEBEL 58 et seq.; HUMMER 374, where no distinction is drawn between follow-the-fortunes and follow-the-settlements. In this regard, see also *Aetna Casualty and Surety Co v The Home Insurance Co*, 882 F Supp 1328, 1345 et seq.). This has been pointed out quite clearly by GERATHEWOHL:

Upon reflection, one sees that reinsurance customs are, in reality, not always as uniform as one might assume. Moreover, there are certain differences not only in customs – particularly between the Continental and the British market systems – but also in terminology: Terms which appear uniform at first sight may have a different meaning in different markets and, depending on the legal concepts applied, in different contexts. (GERATHEWOHL 488)

Quite frequently, lawyer use the principles of their national laws as a frame of reference in relation to a particular reinsurance custom. German authors, for example, view the duty to follow as a manifestation of the unauthorized management of the affairs of another (*negotiorum gestio*), resulting in an application of the relevant provisions in § 677 BGB (*German Civil Code*) (see CANNAWURF & SCHWEPCKE § 8, 76), or refer to § 677 BGB in order to ascertain the standard of care required of a reinsured in exercising its right to business management (LOOSCHELDERS §209 VVG, 60 with footnote 100). The national legal context in which reinsurance customs are perceived and dealt with clearly influences the purportedly “international” reinsurance custom and provide it with a “national flavor”, often leading to differences in outcome.

On examination of statutory law and case law concerning reinsurance contracts, national differences also become apparent. In the UK, both direct insurance and reinsurance are generally considered to fall within the scope of legislation on insurance contracts, primarily the *Marine Insurance Act 1906* and the relatively new *Insurance Act 2015* (BROOK 50; Explanatory Notes to the Insurance Act 2015, 36; cf. also THOMAS 1565). The opposite is often true in civil law jurisdictions, where reinsurance contracts are often excluded from the scope of national codifications on insurance contract law (Germany: § 209 *Versicherungsvertragsgesetz (VVG)*; France: Article L 111-1 *Code des assurances*; Luxembourg: Article 4(4) *Loi du 27 juillet 1997 sur le contrat d'assurance*; Finland: Section 1(3) *Insurance Contract Act No 543*; Switzerland: Article 101(1)(1) *Versicherungsvertragsgesetz (VVG)*; Principality of Liechtenstein: Article 63 *Versicherungsvertragsgesetz (VersVG)*; Austria: § 186 *Versicherungsvertragsgesetz (VersVG)*; Belgium: Article 54 *Loi relative aux assurances du 4 avril 2014*; Netherlands: Article 7:927 *Nieuw Burgerlijk Wetboek Boek 7 titel 7 Verzekering*; for Brazilian law, see MELLO 82 et seqq.; exceptions: Italy: Articles 1928 et seqq. *Codice Civile* and Spain: Articles 77 et seqq. *Ley 50/1980 de 8 octubre, de contrato de seguro*, provide for statutory rules with regard to reinsurance contracts). Furthermore, it also remains unclear, at least in detail, as to whether existing

rules concerning direct insurance may in any way be applied analogously to reinsurance contract (MELLO 83; CANNAWURF & SCHWEPCKE § 8, 38 et seqq.; cf. GERATHEWOHL 398 et seqq.; GEIGER 108 et seqq.; REYMOND 399). Consequently, there is a general lack of transparency where the standards governing reinsurance-specific issues are concerned.

While a fairly considerable body of case law is available in the UK and other Anglo-American jurisdictions, the case law regarding reinsurance contracts among these jurisdictions is by no means uniform, as illustrated by the discussion of implied terms above; in fact, there are substantial differences. Leading practitioners have, for example, highlighted the fact that a follow-the-settlements clause “may have a very different meaning when it is interpreted in the light of New York law than that of England” (CLYDE & CO 20.1; HOFFMAN 75 with regard to the different meanings of “follow the settlements” under German law and US law). In contrast, there is an almost total lack of case law on this matter in civil law jurisdictions (CANNAWURF & SCHWEPCKE § 8, 63; cf. GERATHEWOHL 453 et seq.; there are isolated court decisions on reinsurance law in Switzerland: Swiss Federal Supreme Court Judgment, *BGE 107 II 196*; Swiss Federal Supreme Court Judgment, *BGE 140 III 115*; Swiss Federal Supreme Court Judgment of 4 October 2017, *4A_150/2017*). Where arbitral awards are concerned, knowledge thereof and access thereto are largely restricted for the purposes of maintaining confidentiality (QUINTO 4; cf. GERATHEWOHL 452; O’NEILL & WOLONIECKI 1-024; NEBEL 59), suggesting that a comprehensive overview of such awards is not even available to industry experts (cf. GERATHEWOHL 452). Due to these factors, the predictability of the outcome of potential disputes is reduced.

b. Implications of the status quo for reinsurance contracts

The considerations discussed above clearly have ramifications for reinsurance contracts. Where, for example, the law at the registered office of its cedent governs the contracts entered into by a reinsurer, contracts using uniform wording entered into in various jurisdictions will have different effects. Therefore, an underwriter should, for example, be aware of the fact that an identically worded follow-the-settlements clause contained in such contracts will likely not be interpreted uniformly. It will, consequently, be necessary for the reinsurer to adapt its contracts to the respective law of a cedent. As such adaption is only partly possible in practice, reinsurers will incidentally be exposed differences arising through the application of foreign law.

The opposite is true, in principle, in relation to a reinsured, whose own, familiar law will govern its reinsurance contracts. Despite this fact, a reinsured is by no means guaranteed legal certainty. There is namely a degree of uncertainty surrounding the question of how a court or arbitral tribunal determine a specific dispute, in particular where no statutory law or case law on reinsurance exists. In turn, this uncertainty will impact the parties’ dealings with each other, thereby creating future uncertainty.

While courts or arbitral tribunals may refer to relevant foreign case law, this is not a reliable solution for a number of reasons. First, case law from foreign jurisdictions typically does not have any binding effect in the jurisdiction concerned and at best constitutes persuasive authority. This is the case where courts or arbitral tribunals in civil law jurisdictions refer to case law in Anglo-American jurisdictions (cf. Swiss

Federal Supreme Court Judgment, *BGE 140 III 115*, consideration 6.3, expressly referring to English case law on reinsurance contracts). Second, in referring to foreign case law, it may be unclear which precedent should be relied on as persuasive authority. Due to a lack of detailed default rules, a frame of reference and binding terminology, courts and arbitral tribunals are left to devise their own methods of interpretation.

c. Conclusion

In light of the above, it becomes clear that uniform default rules of reinsurance contract law, a uniform system and standardized terminology would alleviate the problems around interpretation of reinsurance contracts by providing a sound basis for consistent interpretation. It is due to the fact that such default rules do not yet exist, at least not at a cross-border, transnational level, that the Project Group aims at providing uniform rules on reinsurance contract law for reinsurance markets. To some extent, the aim of increasing legal certainty in relation to reinsurance transactions is similar to those underlying regulators' initiatives to enhance "contract certainty" (see, in more detail, HEISS (2018)).

4. The instrument: non-binding soft law

The PRICL have been drafted as "soft law", rather than as a model law requiring implementing national, international or supranational legislation. Their soft law nature means that, rather than being imposed on parties to a contract, the PRICL will only apply when chosen by parties as the law governing their contract (such choice is available in contracts with arbitration clauses pursuant to Article 28(1) of the *UNCITRAL Model Law on International Commercial Arbitration (1985/2006)*; currently, 80 states in 111 jurisdictions have based their arbitration law on the *UNCITRAL Model Law for International Commercial Arbitration*, see <http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/1985Model_arbitration_status.html>, last accessed on 1 April 2019) or incorporated into their contract. Where parties make no such choice or incorporation, the PRICL will not apply to their contract. In order for transnational principles to have binding effect, the contracting parties must essentially make a voluntary decision to this effect ("opting in") (cf. PICC, Preamble, Comment 4.a.; BLACKABY ET AL 3.179). In economic terms, the market will therefore determine whether the PRICL will govern reinsurance transactions in the future.

A brief comparison with the applicability of the *Principles of International Commercial Contracts 2016 (PICC)* as drafted by UNIDROIT further indicates that the PRICL may be taken into consideration by courts or arbitral tribunals, as the case may be, even if the parties to a reinsurance transaction have not, at least not expressly, opted in favor for their application. In accordance with the Preamble to the PICC, this may be the case "when the parties have agreed that their contract be governed by general principles of law, the *lex mercatoria* or the like" (OSER 49 et seqq.; MICHAELS (2015) 78 et seqq.; BONELL (2006) 45 et seqq.; PICC, Preamble, Comment 4.b.) and also "when the parties have not chosen any law to govern their contract" (OSER 61 et seqq., 131 et seqq.; MICHAELS (2015) 82 et seqq.; BONELL (2006) 46 et seqq.; PICC, Preamble, Comment 4.c.). Furthermore, they may *be used* "to interpret or supplement domestic law"

(MICHAELS (2015) 108 et seqq.; BONELL (2006) 46 et seqq.; PICC, Preamble, Comment 6).

5. Structure of the PRICL

Chapter 1 of the PRICL contains general provisions governing structural issues and the connection between the PRICL and the PICC. From Chapter 2 onwards, the PRICL contain specific rules on reinsurance contract law. Chapter 2 deals with the mutual duties of the contracting parties. The formulation of the individual duties is based on the general duty to observe the utmost good faith (THOMAS 1548 et seqq.). Chapter 3 supplements Chapter 2 with remedies in the event of a breach of duty. In line with their basic approach, these remedies are based on the principle of proportionality. Chapter 4 regulates issues concerning allocation. Chapter 5 governs issues concerning aggregation. In particular, it provides definitions of the unifying factors “event” and “(common) cause”. So far, the understanding and use of these terms by courts and in legal literature have varied considerably (cf. CLYDE & CO 28.1 et seqq. with regard to these notions under English law; cf. CANNAWURF & SCHWEPCKE § 8, 353 et seqq. with regard to the German understanding of aggregation clauses).

6. Uniform rules of general contract law: The PICC

The PRICL contain reinsurance-specific rules of contract law. They refrain from regulating issues of general contract law. Such rules are already provided by the PICC, a new version of which was made available in 2016 (see <<https://www.unidroit.org/instruments/commercial-contracts/unidroit-principles-2016>>, last accessed on 1 April 2019). According to the Preamble, the PICC contain “general rules for international commercial contracts”. This means that they govern every issue relating to general contract law applicable to commercial contracts, in particular freedom of contract which prevails in commercial law (Article 1.1). With regard to the detailed rules, Chapter 4 of the PICC (Articles 4.1 - 4.8), which establishes uniform rules for contract interpretation, should be highlighted in particular; the same is true of Chapter 2 of the PICC (Articles 2.1.1 - 2.2.10), which lays down rules governing the formation of the contract, and Chapter 7 of the PICC (Articles 7.1.1 - 7.4.13), which lays down rules governing non-performance.

The PICC are of outstanding importance to the PRICL Project. Firstly, the PRICL Project itself was to a certain extent inspired by the UNIDROIT PICC. In both of the initiatives, creating a kind of global Restatement (BONELL (2004) 9 et seqq.; MICHAELS (2015) 3) or background law (MICHAELS (2014) 643-668) is the goal. The PRICL are also closely based on the PICC in terms of their structure. In addition to the classification into Chapters, Sections and Articles, they follow the internal structure of the PICC using Articles, Comments and Illustrations (cf. VOGENAUER 32 et seqq.).

Secondly, the PRICL Project would not adequately meet the needs of reinsurance business if it restricted itself to rules specific to reinsurance. As illustrated above, the differences arising between national legal systems on questions of general contract law (formation of contract, interpretation of contracts, etc.) lead in no small part to legal uncertainties (NEBEL 60). Therefore, uniform reinsurance soft law cannot restrict itself to reinsurance-specific rules; it must provide rules on general contract law as well. The

PRICL are in a position to provide such rules by referring to and thus incorporating the PICC (see MICHAELS (2009) 885 et seqq.).

Substantively, the PICC are especially suited to constituting the general contract law governing reinsurance contracts. Reinsurance business is internationally oriented and of global importance (QUINTO 3; CANNAWURF & SCHWEPCKE § 8, 20; THOMAS 1556; RODGER 380). This corresponds to the global perspective taken by the PICC, which embody the common legal culture of modern commercial law (MICHAELS (2015) 14). It is this that distinguishes them from both national principles, in particular the US American Restatements, and regional rules, in particular the Principles, Definitions and Model Rules of European Private Law, i.e. the so-called Draft Common Frame of Reference of European Private Law (MICHAELS (2015) 14). Furthermore, reinsurance business is concerned with genuine commercial contract law (CANNAWURF & SCHWEPCKE § 8, 43). An equivalent stance is found in the PICC, which, from the outset, are directed towards commercial contracts and therefore carry the commercial spirit (PICC, Preamble, Comment 2; MICHAELS (2015) 26 et seqq.). In this regard too, the PICC differ from the Principles of European Private Law, which are not restricted to commercial transactions and ultimately also aim to protect the weaker contracting party, especially consumers (cf. MICHAELS (2015) 27). Another advantage of the PICC is that they are regularly updated. Originally published in 1994, the current version from 2016 is already the 4th edition of the PICC (MICHAELS (2015) 22 et seqq.; see also <<https://www.unidroit.org/instruments/commercial-contracts/unidroit-principles-2016>>, last accessed on 1 April 2019). Moreover, the publication of the PICC always includes Comments and Illustrations, which explain the wording of the Principles (Comments) and exemplify their application with typical examples (Illustrations) (VOGENAUER 32). In cooperation with other partners, UNIDROIT also maintains a website (<www.unilex.info>) where case law, court decisions and arbitral awards in particular, as well as legal literature on the PICC are made available (see <<http://unilex.info/dynasite.cfm?dssid=2377&dsmid=14311>>, last accessed on 1 April 2019). All of this facilitates the application of the PICC to specific situations.

It should also be noted that an otherwise significant reason for the parties to refrain from applying the PICC does not exist where the PRICL are concerned. As pointed out in legal literature, one of the reasons that contracting parties often do not choose the PICC as the law applicable to their contract is that the Principles lack rules governing special types of contracts (MICHAELS (2014) 663). This problem is resolved by the fact that the PRICL provide rules on reinsurance, a special contract type, while any contract law matters not governed by the PRICL will be subject to the UNIDROIT PICC pursuant to Article 1.1.2 PRICL. Thus, it is truly the first time that a special contract type, reinsurance, will be governed by the PICC together with specific rules. In other words, the PICC and PRICL must be viewed as a uniform package. It will become an attractive option to make a combined choice in favor of the PICC and PRICL as the law applicable to a reinsurance contract.

7. Future work

Publication of the PRICL 2019 does not mark the end of the PRICL project. While the Project Group has succeeded in drafting rules on several important topics of reinsurance contract law, there are still topics to be covered in the future, among them questions

relating to back-to-back coverage, coverage of extra-contractual liability, the reinsurance period and prescription. In order to cover these topics, the Project Group has been awarded another research grant by the Swiss National Science Fund (SNSF) and the German Research Foundation (DFG) for an additional project period of 3 years beginning on 1 June 2019 through to 31 May 2022. The final work will be published soon thereafter.

Final Draft - subject to linguistic amendments

CHAPTER 1

General Provisions

SECTION 1: APPLICATION OF THE PRICL

ARTICLE 1.1.1

(Substantive Scope of Application)

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

COMMENTS¹

1. Relationship to the PICC

- C1. Article 1.1.1 is modelled on paragraph 2 of the Preamble to the UNIDROIT Principles of International Commercial Contracts (PICC). According to paragraph 2, the PICC “shall be applied when the parties have agreed that their contract be governed by them.” The same rule is set out in Article 1.1.1 in relation to reinsurance contracts.
- C2. Paragraphs 3 – 7 of the Preamble to the PICC, which list the other forms of applying or using the PICC, have not been adopted by the PRICL. This underscores the fact that the PRICL primarily provide the parties with an option, the exercise of which is at their discretion. This emphasis on an opting-in by the parties does not, however, prevent the parties involved from applying or taking into account the PRICL in a different manner.
- C3. In paragraph 3 of the Preamble, for example, the PICC are declared applicable even if the parties have subjected their contract to general principles of law, the *lex mercatoria* or the like. The PICC can be regarded as a codification of these general principles of law, the *lex mercatoria* or the like. This is also likely to apply, at least to a certain degree, to the PRICL. Where this is the case, a court or arbitral tribunal may also have recourse to the PRICL if the parties have agreed to the application of general principles or the *lex mercatoria*. The situation is similar in respect of paragraph 4 of the Preamble to the PICC, pursuant to which the PICC may even be applied in cases where the parties have not made such a choice, provided that they have also not chosen any other law. Insofar as the PRICL restate reinsurance customs, they can be referred to as part of the law applicable. In this context, the PRICL may also be taken into account in interpreting and supplementing domestic reinsurance contract law, in manner similar to the PICC pursuant to paragraph 6 of the Preamble to the PICC. The options provided in paragraphs 5 (interpretation and supplementation of uniform law) and 7 (model law character of the PICC) are unlikely to play a role in relation to the scope of the PRICL.

¹ The project members thank Dr. Ulrike Mönnich and Christopher Bell for their valuable input in the course of editing this Article and the Comments.

There is no international uniform law governing reinsurance contracts. Legislation at national, international or supranational level is not expected.

2. Scope of application

- C4. In Article 1.1.1, the scope of application of the PRICL is limited to “contracts of reinsurance”. These contracts are described in Article 1.2.1.
- C5. Unlike paragraph 1 of the Preamble to the PICC, the scope of application of the PRICL is not limited to “international” contracts of reinsurance. Such limitation did not appear to be necessary. Contracts of reinsurance are, in fact, frequently international contracts. Even when this is not the case, however, parties enjoy a high degree of freedom of contract under national reinsurance law and, thus, may largely substitute domestic legal rules by incorporating the PRICL into their contract. Moreover, a national contract of reinsurance will, at times, form an integral part of an international reinsurance scheme. It is in such situations in particular that the PRICL must also apply to domestic contracts of reinsurance.

3. Application by choice of law

a. General remarks on the effects of a choice of law

- C6. Pursuant to the rules of private international law and conflict of laws, an agreement between the parties to a reinsurance contract declaring the PRICL as applicable thereto usually represents a choice in favor of soft law and consequently of a non-State body of law. The effects of such a choice are determined by the private international law applicable.

b. Option 1: Choosing the PRICL is equivalent to a choice of national law

- C7. Insofar as a choice in favor of the PRICL is treated as a choice of a national law under the private international law applicable, the PRICL and with them the PICC both supersede the national law which would apply in absence of a choice of law. This substitution is generally comprehensive; it also affects provisions in domestic law from which the parties are unable to derogate contractually (mandatory provisions). The only exemption is made in relation to violations of public policy and the enforcement of so-called internationally (or overriding) mandatory rules (dealt with separately in Article 1.1.5 below).

Illustrations

- II. Reinsurer A and Reinsured B enter into a reinsurance contract containing a choice of law in favor of the PRICL. Later, the parties dispute whether the shortening of the prescription periods by contractual agreement is effective. While the agreement fulfills the requirements set out in Article 10.3 PICC, it contradicts the mandatory prescription periods prescribed by the law in country X, which would apply to the reinsurance in absence of a choice of law. As a choice in favor of the PRICL has the same effect as a choice of national law, the mandatory prescription periods prescribed by the law of country X do not

apply. Prescription periods, in general, do not constitute “overriding mandatory rules” nor does the shortening of the prescriptions periods violate public policy.

- I2. Same facts as above, but the parties later dispute whether the reinsurance contract is void because it breaches international sanctions supported by the country in which the reinsurer is seated. As international sanctions frequently constitute “overriding mandatory rules”, they will be imposed despite the fact that a choice in favor of the PRICL is equivalent to a choice of national law.
- C8. A choice of soft law and a choice of a domestic law are predominately treated in such an equivalent manner where contracts containing an arbitration clause are concerned. In respect of choice of law, numerous national arbitration laws emulate the *UNCITRAL Model Law on International Commercial Arbitration 1985/2006*. Under Article 28(1), parties may choose “rules of law” as the law governing the contract. Since the term “rules of law” in Article 28(1) *UNCITRAL Model Law* also encompasses non-State law, the PRICL will qualify as a set of rules which may be chosen by the parties. Consequently, by virtue of such a choice, the PRICL together with the PICC will take precedence over the law otherwise applicable with the exception of its public policy and the enforcement of its so-called internationally (or overriding) mandatory rules.
- c. Option 2: Choosing the PRICL is equivalent to an incorporation of their provisions into the contract**
- C9. Insofar as a choice in favor of the PRICL is not treated as a choice of a national law under the private international law applicable, the PRICL and by virtue of their application the PICC cannot completely prevail over the national law which would apply in absence of a choice of law. A choice by the parties will therefore merely represent an incorporation of the PRICL into the contract, such that the PRICL provisions will only substitute the default rules of national law. Any provisions from which contractual derogation is not permitted under the substantive contract law applicable will take precedence over the PRICL.
- C10. Such difference in treatment between a choice of soft law and a choice of a national law occurs pursuant to the rules of private international law in cases where contracts do not contain an arbitration clause and disputes are consequently heard by domestic courts. For instance, EU rules of conflict of laws, i.e. the *Rome I Regulation (Regulation (EC) No 593/2008 on the law applicable to contractual obligations)*, do not permit a choice in favor of a non-State body of law. With a view to such a choice, Recital 13 of the *Rome I Regulation* indicates: “This Regulation does not preclude parties from incorporating by reference into their contract a non-State body of law or an international convention.” Under this concept, the PRICL will be construed as contract terms. Where rules in the PRICL are inconsistent with mandatory provisions of the governing law, the latter will prevail.

Illustration

- I3. Reinsurer A and Reinsured B enter into a reinsurance contract which incorporates the PRICL by reference. Later, the parties dispute whether the shortening of the prescription periods by contractual agreement is effective.

While the agreement fulfills the requirements set out in Article 10.3 PICC, it contradicts the mandatory prescription periods prescribed by the law in country X, which is the law governing the reinsurance contract. Since the PRICL operate as contract terms they will be superseded by the mandatory prescription periods of the law of country X.

C11. At first sight, *the Hague Principles on Choice of Law in International Commercial Contracts* appear to be more liberal and permit a choice in favor of non-State bodies of law. Article 3 states “the law chosen by the parties may be rules of law that are generally accepted on an international, supranational or regional level as a neutral and balanced set of rules”. The provision nevertheless ultimately gives precedence to any restrictions imposed by national rules of conflict of laws, which will lead to a limited choice of non-State bodies of law only.

C12. In respect of reinsurance, however, most national jurisdictions have very few mandatory contract law provisions. Therefore, the PRICL and the PICC largely take precedence over the law applicable, even if they have only been incorporated into the contract.

4. Regulatory constraints

C13. Restrictions on the choice of law may also be imposed by national supervisory law. Such laws may oblige direct insurers to enter into their reinsurance contract in accordance with national law. Sometimes, supervisory rules do not directly prohibit a choice in favor of foreign law, but make such a choice unattractive by attaching economically disadvantageous legal consequences to it.

C14. An example of both types of restrictions is provided by Australian law. Under paragraph 34 of the *General Insurance Prudential Standard GPS 230*, laid down by the Australian Prudential Regulation Authority (APRA), parties to a reinsurance contract in the Australian non-life insurance sector must make Australian law applicable. This compulsory requirement does not directly apply to life insurance; by virtue of the solvency rules, it does however indirectly force reinsurance to be taken out with reinsurers licensed in Australia. This also leads, as a general rule, to the application of Australian law.

C15. In a similar vein, Article 38 of *Resolution 168/07 of the Brazilian National Council of Private Insurance (Conselho Nacional de Seguros Privados (CNSP))* requires reinsurance contracts covering risks situated in Brazil to include a choice of law clause in favor of Brazilian law.

C16. Clearly, the PRICL may also be declared applicable by the parties in such cases. A choice in their favor would however have to take place by virtue of their incorporation into the contract of reinsurance in accordance with the respective substantive contract law. In light of the largely unrestricted freedom of contract, this appears to be readily possible.

5. The choice: Express or implied

C17. In general, the parties will make an express choice in favor of the PRICL and document the choice in the reinsurance contract. It is, however, also possible for a choice in favor of the PRICL to be made implicitly. This will be the case when the contract does not contain an express choice of law in favor of the PRICL, but a perusal of the agreement in its entirety leaves no serious doubt that the parties wished to invoke the application of the PRICL. The will of the parties to this effect would, for example, be assumed when the contract repeatedly refers to the PRICL, so that its provisions are established on the basis of the PRICL.

6. Model Clauses for a choice of the PRICL

C18. To facilitate a choice of the PICC, UNIDROIT has drafted and published Model Clauses in various versions (<https://www.unidroit.org/instruments/commercial-contracts/upicc-model-clauses>). Some of these UNIDROIT Model Clauses may be used *mutatis mutandis* in respect of a choice of the PRICL, which also encompasses a choice of the PICC pursuant to Article 1.1.2 PRICL. Doing so results primarily in the following two versions.

Illustrations

I4. Conflict-of-laws choice of law in favor of the PRICL

Base clause

This contract shall be governed by the Principles of Reinsurance Contract Law (2019).

Base clause with an addition for gap-filling

(a) This contract shall be governed by the Principles of Reinsurance Contract Law (2019) *and, with respect to issues covered neither by such Principles nor by the UNIDROIT Principles of International Commercial Contracts (2016), by generally accepted principles of international commercial law.*

(b) This contract shall be governed by the Principles of Reinsurance Contract Law (2019) *and, with respect to issues covered neither by such Principles nor by the UNIDROIT Principles of International Commercial Contracts (2016), by the law of [State X].*

I5. Incorporation of the PRICL into the contract

Base clause

The Principles of Reinsurance Contract Law (2019) are incorporated into this contract to the extent that they are not inconsistent with the other terms of the contract.

Base clause together with a choice of law clause in favor of domestic law

This contract is governed by the law of [State X]. The Principles of Reinsurance Contract Law (2019) are incorporated into this contract to the extent that they are not inconsistent with the other terms of the contract.

ARTICLE 1.1.2

(External Gaps)

Issues not settled by the PRICL shall be settled in accordance with the UNIDROIT Principles of International Commercial Contracts 2016 (“PICC”).

COMMENTS

1. Relationship to the PICC

C1. Article 1.1.2 is a stand-alone provision. It is not modelled on any provision of the PICC.

2. Scope of application: External gaps

C2. Article 1.1.2 deals with “issues not settled by the PRICL”. This does not refer to every gap left by the PRICL provisions, but only to so-called external gaps, as indicated by the title of the Article. The term “external gaps” refers to issues for which the PRICL do not claim to provide any guidance, such as agency relationships. Such external gaps are dealt with under Article 1.1.2. In contrast, if an issue falls within the scope of, but is not settled by the PRICL, the unresolved issue gives rise to an internal gap. Internal gaps are not subject to Article 1.1.2; they are instead filled in accordance with Article 1.1.6(2).

3. Gap-filling by reference to the PICC

C3. Article 1.1.2 provides that questions which do not fall within the scope of the PRICL shall be determined in accordance with the PICC.

C4. However, the PICC are also incomplete and may give rise to external gaps. External gaps within the PICC are generally supplemented by recourse to the domestic law chosen by the parties. In absence of a choice of domestic law, external gaps within the PICC may be filled by reference to the law applicable in accordance with the applicable rules of private international law.

Illustrations

- II. German reinsurer A and US direct insurer B agree that the PRICL shall govern their reinsurance contract. Assuming that the PRICL contain a gap with regard to a specific question concerning B’s pre-contractual duty to disclose material information to A, as the duty of pre-contractual disclosure is expressly dealt with by the PRICL, gaps in this regard are to be considered internal gaps.

Article 1.1.6(2) provides that such gaps are, to the extent possible, to be settled in accordance with the PRICL's underlying principles so that no recourse to external rules shall be had.

- I2. Same facts as in Illustration 1, this time assuming that the PRICL contain a gap with regard to the formation of the reinsurance contract. As the PRICL do not provide rules on contract conclusion, they contain an external gap in this respect. Article 1.1.2 provides that external gaps shall be settled with the PICC. In order to fill this gap, recourse shall be had to the PICC.
- I3. Same facts as in Illustration 1, this time assuming that the PRICL contain a gap with regard to the authority of organs, officers or partners of either A or B to act on their behalf. As the organ's authority does not fall within the scope of the PRICL, they contain an external gap in this respect. Article 1.1.2 provides that external gaps shall be settled in accordance with the PICC. In Articles 2.2.1 ff PICC, the principles contain general rules with regard to the authority of agents. In Article 2.2.1 Comment 5 PICC, however, it is stated that as far as the question of authority of organs, officers or partners is concerned special national rules prevail over the general rules in Articles 2.2.1 ff PICC. In this case, an arbitral tribunal or court, as the case may be, is required to have recourse to the national proper law with regard to this question.
- I4. Same facts as in Illustration 1, this time assuming that the PRICL contain a gap with regard to A's capacity to contract. As the parties' capacity to contract does not fall within the scope of the PRICL, they contain an external gap in this respect. Article 1.1.2 provides that external gaps shall be settled in accordance with the PICC. However, Article 3.1.1 PICC provides that the question of capacity to contract does not fall within the scope of the PICC. In this case, an arbitral tribunal or court, as the case may be, is required to have recourse to the national proper law with regard to this question.

ARTICLE 1.1.3

(Exclusion or Modification of the PRICL)

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

COMMENTS

1. Relationship to the PICC

- C1. Article 1.1.3 is modelled on Article 1.5 PICC.

The main difference is that there is no exception to the non-binding character of the PRICL. Notwithstanding this principle, individual rules contained in the PRICL may bear a mandatory element following from the content and purpose of the rule. For example, parties will not be allowed to exclude the application of the duty to observe

utmost good faith. They may, however, modify particular aspects of it in appropriate situations, such as modify a particular duty resulting from an application of utmost good faith. This is similar to the PICC (see Article 1.5 Comment 3 PICC)

Moreover, the wording of Article 1.5 PICC has been changed slightly to reflect the fact that an exclusion of the whole body of rules is not a realistic option where the PRICL are concerned. Since they will only be applicable upon a positive choice (“opting in”) by the parties, there will be no need for and no case of an entire exclusion. Parties who have opted into the PRICL may wish to exclude or modify some of its provisions, but they will not exclude the application of the PRICL as a whole.

2. PRICL provide a set of non-mandatory rules

- C2. If parties opt in favor of the PRICL in accordance with Article 1.1.2, they do not have to accept the PRICL as the Principles stand; they may derogate from or alter them by agreement. This is due to the non-mandatory nature of the PRICL which provide for no more than gap filling rules in case parties to a reinsurance transaction have not specifically settled a contractual issue in their contract.
- C3. The non-mandatory nature of the PRICL is justified, because there are no policy reasons to restrict 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. At the same time, there are no public interest concerns requiring protection by mandatory reinsurance rules.

3. Limitations on freedom of contract under the PICC will also apply to reinsurance transactions

- C4. While basic principles of law, such as the prohibition of fraudulent behavior or compliance with principles of utmost good faith (“*uberrima fides*”), may be considered mandatory and not at the discretion of the parties, the mandatory nature of such general principles is already safeguarded by Article 1.5 of the underlying PICC:

The parties may exclude the application of these Principles or derogate from or vary the effect of any of their provisions, *except as otherwise provided in the Principles*.

- C5. With a view to the very few mandatory rules within the PICC, Article 1.5 Comment 3 PICC states:

A few provisions of the Principles are of a mandatory character, i.e. their importance in the system of the Principles is such that parties should not be permitted to exclude or to derogate from them as they wish. It is true that given the particular nature of the Principles the non-observance of this precept may have no consequences. On the other hand, it should be noted that the provisions in question reflect principles and standards of behavior which are of a mandatory character under most domestic laws also.

Those provisions of the Principles which are mandatory are normally expressly indicated as such. This is the case with Article 1.7 on good faith and fair dealing, with the provisions of Chapter 3 on substantive validity, except in so far as they relate or apply to mistake and to initial impossibility (see Article 3.1.4), with Article 5.1.7(2) on price determination, with Article 7.4.13(2) on agreed payment for non-performance and

Article 10.3(2) on prescription periods. Exceptionally, the mandatory character of a provision is only implicit and follows from the content and purpose of the provision itself (see, e.g., Articles 1.8 and 7.1.6).

[Note: For reference to specific Articles of the PICC, see Annex B.]

These general limitations on freedom of contract will also suffice in the specific context of reinsurance.

4. Exclusion or modification of the PRICL may be express or implied

- C6. 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.

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

- C7. Parties may exclude certain parts of the PRICL simply by choosing or incorporating into the contract only some specific, but not all parts of the PRICL. In such case, it will be presumed that parties want the chosen chapters of the PRICL to be applied together with the general provisions (Articles 1.1.1 - 1.2.2; see also Article 1.5 Comment 2 paragraph (2) PICC).

ARTICLE 1.1.4

(Usages and Practices)

(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.

COMMENTS

1. Relationship to the PICC

- C1. Paragraph (1) replicates Article 1.9(1) PICC.
- C2. Paragraph (2) is a stand-alone provision not modelled on any sample provision. Although it differs significantly from Article 1.9(2) PICC, it is in line with Article 4.3(f) PICC. This provision provides that in interpreting contracts regard shall be had to, *inter alia*, usages.

2. Paragraph (1): Practices established between the parties

- C3. The practices established between the parties have binding force in line with Article 1.9 PICC and will continue to do so as long as parties have not derogated from them by contractual agreement. In line with Article 1.9 Comment 2 PICC, it may be said that the question of “[w]hether a particular practice can be deemed to be ‘established’ between the parties will naturally depend on the circumstances of the case, but behavior on the occasion of only one previous transaction between the parties will not normally suffice” (see also the illustration presented in that Comment).

3. Paragraph (1): Usages chosen by the parties

- C4. Following the principle of freedom of contract, parties may agree on the application of any particular usage. Such usage will apply to the contract irrespective of whether it complies with the PRICL or not.

4. Paragraph (2): Other usages

- C5. Where parties do not agree on the application of a particular usage, the question arises as to whether such usage shall prevail over the PRICL. In paragraph (2), it is made clear that such usage may only be considered if it is “regularly known to and observed by parties to a reinsurance contract”. But even then, such usage will only be taken into account for the purpose of contract interpretation, which is in line with Article 4.3(f) PICC. Thus, the PRICL do not give precedence to usages in general. In this point, the PRICL differ substantially from the PICC (see Article 1.9 Comment 6 PICC). The reason for this is that the PRICL are intended to be a Restatement of international reinsurance usage and provide parties with an alternative to the usages found in the reinsurance markets. In contrast, the PICC codify general principles of law, not trade usages. Within the scope of the PICC, it therefore makes sense to give precedence to trade usages.
- C6. 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. In using this discretion, ensuring uniform application of the PRICL must be weighed against the need to allow for continuing development of the law of reinsurance.

ARTICLE 1.1.5*(Mandatory Rules)*

Application of the PRICL shall not restrict the application of mandatory rules, whether of national, international or supranational origin, where applicable.

COMMENTS

1. Relationship to the PICC

- C1. Article 1.1.5 is modelled on Article 1.4 PICC. In contrast to Article 1.4 PICC, Article 1.1.5 does not refer to the “rules which are applicable in accordance with the relevant rules of private international law”. This is due to the fact that a reinsurance contract may be governed or affected by mandatory supervisory rules or public policy considerations stemming from the laws of a country different to the one providing the proper law in accordance with the relevant private international law rules.

2. “Mandatory rules”

- C2. The relevant mandatory rules differ depending on whether or not parties have agreed to include an arbitration clause. Rules of arbitration usually allow for a choice to be made in favor of non-State law as the law governing the contract and, thus, only give precedence to “overriding” or “internationally mandatory” provisions in accordance with Article 1.1.5. In contrast, courts will usually consider a choice in favor of non-binding rules to lead to their incorporation into the contract and, thus, apply even so-called “ordinary” or “domestically mandatory” rules.

- C3. The difference has been explained well in Article 1.4 Comments 3 and 4 PICC:

3. Mandatory rules applicable in case of incorporation of the Principles as terms of contract

Where, as is the traditional and still prevailing approach adopted by domestic courts with respect to soft law instruments, the parties’ reference to the Principles is considered to be merely an agreement to incorporate them in the contract (see ...), the Principles and the individual contracts concluded in accordance with the Principles will first of all encounter the limit of the principles and rules of the domestic law that govern the contract from which parties may not contractually derogate (so-called “ordinary” or “domestically mandatory” rules). Moreover, the mandatory rules of the forum State, and possibly of other countries, may also apply if the mandatory rules claim application irrespective of what the law governing the contract is, and, in the case of the mandatory rules of other countries, there is a sufficiently close connection between those countries and the contract in question (so-called “overriding” or “internationally mandatory” rules).

4. Mandatory rules applicable in case of reference to the Principles as law governing the contract

Where, as may be the case if the dispute is brought before an arbitral tribunal, the Principles are applied as the law governing the contract (see ...), they no longer encounter the limit of the ordinary mandatory rules of any domestic law. As far as the overriding mandatory rules of the forum State or of other countries are concerned, their application basically depends on the circumstances of the case. Generally speaking, since in international arbitration the arbitral tribunal lacks a predetermined *lex fori*, it may, but is under no duty to, apply the overriding mandatory rules of the country on the territory of which it renders the award. In determining whether to take into consideration the overriding mandatory rules of the forum State or of any other country with which the case at hand has a significant connection, the arbitral tribunal, bearing in mind its task to “make every effort to make sure that the Award is enforceable at law” (so expressly e.g.

Article 35 of the 1998 ICC Arbitration Rules), may be expected to pay particular attention to the overriding mandatory rules of those countries where enforcement of the award is likely to be sought. Moreover, the arbitral tribunal may consider it necessary to apply those overriding mandatory rules that reflect principles widely accepted as fundamental in legal systems throughout the world (so-called “transnational public policy” or “ordre public transnational”).

3. Relevance of the provision in the context of reinsurance contract law

- C4. Reinsurance *contract* law will provide for very few mandatory rules, if any. Thus, the relevance of Article 1.1.5 PRICL will remain limited in that respect.
- C5. However, a choice in favor of the PRICL cannot prevent the application of *supervisory* law and other provisions of public law or public policy considerations. Such rules are not only effective within the issuing jurisdiction, but may also have extraterritorial effect. The consequences of non-compliance with such rules may differ significantly. In general, the violation of such rules may either have no direct impact on the validity of the reinsurance agreement, result in the impossibility of the latter’s performance, render it partially invalid or invalidate the agreement altogether. Article 1.1.5 will mainly be of relevance to contract-related supervisory rules, public law rules as well as public policy considerations.

Illustrations¹

- I1. Rules concerning the reinsurer’s solvency may impact the right to write reinsurance business.
- I2. Insolvency legislation at the reinsurer’s place of business might render so-called cut-through clauses as well as set-off clauses ineffective if they otherwise disadvantage a certain creditor or a certain class of creditors of the insolvent reinsured.
- I3. Currency export/import rules may affect the performance of a reinsurance contract.
- I4. Data protection rules may render the reinsurers’ right to inspect and audit the reinsured’s books unenforceable.
- I5. Contracts of reinsurance may contain clauses that restrict competition and hence violate competition law. Such clauses may be declared void.
- I6. Rules concerning trade sanctions or embargoes may impact the contract of reinsurance. For example, the European Union has put into force restrictive measures with regard to trading with entities of certain nations (cf. http://eeas.europa.eu/cfsp/sanctions/docs/measures_en.pdf).
- I7. Some jurisdictions provide for mandatory forum selection or choice of law rules. For example, the Brazilian Resolution CNSP 168/2007 mandatorily

¹ These illustrations were inspired by a presentation prepared by Dr. Monica Mächler, Dr. Rolf Nebel and John Pruitt for the Zurich workshop in 2016. The PRICL project members are very grateful for this contribution.

requires that the parties choose Brazilian law as well as a Brazilian forum if the risk to be covered lies within the territory of Brazil. Similarly for non-life business, the Australian General Insurance Prudential Standard GPS 230 requires the reinsurer to ensure that the reinsurance agreement is governed by Australian law and that possible disputes are heard in an Australian court.

- I8. Certain mandatory coverage rules may affect the enforceability of a reinsurance contract. New York state common law, for example, prohibits the coverage of punitive damages.
- I9. Some jurisdictions require its authority's approval of reinsurance agreements. If such approval is not obtained, the agreements may be declared void or voidable.

The information given in Illustrations 1 - 9 is for illustrative purposes only. Mandatory rules not mentioned in the illustrations above may govern a reinsurance agreement. Non-compliance with the rules mentioned in the Illustrations may potentially have different consequences than the ones stated.

ARTICLE 1.1.6

(Interpretation and internal gaps)

(1) In the interpretation of the PRICL, regard is to be had to their international character and to their purposes including the need to promote the observance of good faith and fair dealing in the reinsurance sector and uniformity in the application of the PRICL.

(2) Issues within the scope of the PRICL but not expressly settled by them are as far as possible to be settled in accordance with their underlying principles.

COMMENTS

1. Relationship to the PICC

- C1. Paragraph (1) is modelled on Article 1.6(1) PICC. An addition has been made to reflect one of the PRICL's goals, namely to facilitate the observance of good faith and fair dealing in the reinsurance sector.
- C2. Paragraph (2) replicates Article 1.6(2) PICC. The latter emulates the first alternative in Article 7(2) of the *United Nations Convention on Contracts for the International Sale of Goods (1980) (CISG)*.

2. Scope

- C3. Article 1.1.6 provides guidance with regard to the interpretation of the PRICL as opposed to the reinsurance agreement as such. The PRICL do not prescribe special rules

on contract interpretation. Thus, Chapter 4: Interpretation (Articles 4.1 to 4.8) PICC will be applicable in this respect.

3. Interpretation: Paragraph (1)

- C4. The PRICL can only contribute to legal certainty in the field of reinsurance contract law if they are applied uniformly. Thus, the primary aim behind paragraph (1) is to introduce common rules of interpretation to ensure uniform application of the PRICL. By referring to the “international character” of the PRICL, courts or arbitral tribunals, as the case may be, will be obligated to use methods of comparative law for the sake of uniform application of the PRICL in practice. This is made particularly clear in the last part of paragraph (1) which highlights the “uniformity of application” of the PRICL as a major criterion for their interpretation.
- C5. At the same time, the aim of paragraph (1) is to set out criteria of interpretation which meet the needs of reinsurance. Thus, reference is made to a promotion of good faith and fair dealing in the reinsurance sector.

4. Gaps in the PRICL: Paragraph (2)

- C6. Internal gaps in the PRICL are dealt with in paragraph (2). These are issues not specifically governed by the PRICL even though they fall within the scope of the Principles. This criterion distinguishes internal gaps from external gaps (cf. Article 1.1.2 incl. Comments).
- C7. The aim behind paragraph (2) is to provide a method of determining issues not settled by the PRICL, but falling within their scope of application. Pursuant to paragraph (2), such issues should be settled in accordance with the PRICL’s underlying principles. This may be achieved by analogous application of explicit rules in the PRICL. If the issue cannot be solved by a mere extension of specific provisions dealing with analogous cases, the underlying principles have to be extracted from specific provisions. In order to do so, the specific provisions may be examined in view of their potential to be considered an expression of a more general principle, and as such capable of also being applied to cases different from those specifically governed (see also Article 1.6 Comment 4 paragraph 3 PICC).
- C8. Confronted with an external gap, paragraph (2) does not help. The question of how to fill an external gap is a matter of determining the applicable default law. Under Article 1.1.2, issues not settled by the PRICL shall be settled in accordance with the PICC. As a consequence, the PICC form a set of general contract law rules which will govern reinsurance transactions where there are no special rules available in the PRICL. Rules in the PICC which do not require modification in order to be applied to reinsurance contracts will, thus, not be repeated within the PRICL (cf. Article 1.1.2).

Illustration

- C9. The PRICL do not contain general rules on contract formation. As the formation of a contract is not specific to reinsurance, the issue does not fall within the scope of the

PRICL. When confronted with an external gap, recourse is to be had to the PICC, Articles 2.1.1 ff (Article 1.1.2 PRICL).

SECTION 2: DEFINITIONS

ARTICLE 1.2.1

(Reinsurance Contract)

(1) "Contract of reinsurance" means a contract under which one party, the reinsurer, in consideration of a premium, promises another party, the reinsured, cover against the risk of exposure to insurance and/or reinsurance claims.

(2) Unless otherwise indicated, the term "contract" as used in the PRICL refers to a contract of reinsurance.

COMMENTS

1. Paragraph (1): definition of a contract of reinsurance

- C1. The aim behind paragraph (1) is to provide a description of the nature of a reinsurance contract without attempting to give a scientific definition. The main purpose of the description is to provide a guideline for determining the substantive scope of application of the PRICL in accordance with Article 1.1.1.
- C2. A more detailed, statutory definition of "reinsurance" is provided in Article 13(7) of *Directive 2009/138/EC (Solvency II)*. The provision reads:

(7) 'reinsurance' means either of the following:

(a) the activity consisting in accepting risks ceded by an insurance undertaking or third-country insurance undertaking, or by another reinsurance undertaking or third-country reinsurance undertaking; or

(b) in the case of the association of underwriters known as Lloyd's, the activity consisting in accepting risks, ceded by any member of Lloyd's, by an insurance or reinsurance undertaking other than the association of underwriters known as Lloyd's.

This definition, produced mainly for supervisory purposes, appears to be too technical and complicated for the purposes of the PRICL. This is why such a definition has not been incorporated into paragraph (1).

- C3. Under paragraph (1), contracts of reinsurance are primarily considered to be contracts of insurance. While this issue is ultimately left to legal theory and practice, rather than being addressed specifically in Article 1.2.1(1), the classification of reinsurance as an insurance contract follows from the two main elements of a reinsurance contract: premium and coverage.

- C4. “Coverage” under a reinsurance contract must relate to the reinsured’s risk of being exposed to insurance claims under an insurance contract. The reinsured does not necessarily have to be a private insurance company; it may also be a social insurer, a carrier of an occupational pension scheme, etc. Moreover, reinsurers may be reinsureds themselves, whenever they buy insurance to cover the risk of being exposed to insurance claims under a reinsurance contract. In this context, the term “contract of reinsurance” does encompass retrocession agreements.
- C5. The description provided in paragraph (1) covers both facultative and treaty reinsurance. For an application of the description, it is irrelevant whether reinsurance is provided by a reinsurance company, a captive insurer, a protected cell company, etc.

2. ART and reinsurance pools

- C6. The description provided in paragraph (1) does not include instruments of an alternative risk transfer (ART) as a whole. Such ART instruments are usually complex vehicles involving a series of transactions. Depending on the type of ART vehicle, reinsurance will, however, form a part of the overall model. The parties may, thus, subject the reinsurance part of the model to the PRICL.
- C7. Equally, reinsurance pool agreements are not covered by the term “contract of reinsurance” as they structure and regulate the relations between the different shareholders or partners of the pool’s corporate entity. In contrast, an agreement between a reinsurance pool as a corporate entity and an insurer/reinsurer with regard to reinsurance of the latter’s risk by the pool entity constitutes a “contract of reinsurance” for the purposes of paragraph (1).

3. Ancillary agreements

- C8. A contract of reinsurance might be connected to an ancillary agreement the purpose of which is not to insure a risk. In such cases, the PRICL will apply to the reinsurance agreement only; they will not govern the ancillary agreement. Hence, it is up to the parties to choose the law governing their ancillary agreement. For example, a reinsurance contract may be linked to a trust. In such cases, only the reinsurance relationship will be subject to the PRICL, whereas the trust will be governed by its own proper law.

4. Paragraph (2): Clarification

- C9. In paragraph (2), there is less of a definition and more of a clarification that the PRICL and their Comments may frequently simply use the term “contract” when dealing with a “contract of reinsurance”.

ARTICLE 1.2.2

(Further Definitions)

[Note: to be drafted in the course of the project.]

Final Draft - subject to linguistic amendments

CHAPTER 2

Duties of the Reinsurer and the Reinsured

SECTION 1: GENERAL DUTIES

ARTICLE 2.1.1

(Duties in general)

Throughout the negotiation, formation, operation, termination or avoidance of the contract, the parties owe one another the duties set forth in this Chapter.

COMMENTS

1. Implications of the General Part of the PRICL for Chapter 2 (Duties)

- C1. Subject to any such judicially imposed limits on the alteration of default rules, the duties applicable to reinsurer and reinsured set out in this Chapter are default rules that may be altered by the parties to the reinsurance agreement (see Article 1.1.1) – provided that the alteration of the default rule is knowing and voluntary and not the product of fraud, misrepresentation, duress, undue influence, or other conduct that would make the alteration of the default rule unenforceable pursuant to ordinary contract law. In other words, where the parties have chosen to make the PRICL the applicable law for resolution of disputes arising in a reinsurance relationship, this does not prevent the parties from agreeing on particular rules for specific issues, even if the particular rule chosen is at variance with the PRICL.
- C2. Where the parties have selected the PRICL as the applicable law of a reinsurance contract, the PRICL govern all aspects of any contractual dispute addressed by the provisions of the PRICL. Where the PRICL do not provide guidance or a rule for resolution of a dispute, the dispute is governed by the PICC (see Article 1.1.2). If neither the PRICL nor the PICC provide guidance or a controlling rule of decision, the dispute shall be resolved according to applicable national law (see Article 1.1.2 Comment 4).
- C3. Chapter 2 determines the duties owed by the parties one another. However, it abstains from giving remedies for breach of duty by either party. Such remedies are provided in Chapter 3.

2. The duties set forth in the PRICL apply to all stages of the reinsurance contract relationship

- C4. The duties owed between and among parties to a reinsurance contract affect the entire relationship of the parties. Although litigation and arbitration disputes often focus on pre-contractual duties of disclosure, the respective duties of the parties apply regarding

the entire contract process and operation of the contract, including duties of good faith applicable to questions of confidentiality, documentation, allocation, and performance of the reinsurance contract generally.

- C5. A general duty of utmost good faith is imposed on parties to a reinsurance contract (see Article 2.1.2). This duty applies not only to pre-contract activity but to the entire performance of the contract. See Article 1.7 PICC Comment 1 (the parties' behavior "*throughout* the life of the contract, including the negotiation process, must conform to good faith and fair dealing")(emphasis added).
- C6. A reinsured that was completely candid during the contracting process is not relieved of the duty after the agreement is made and logically remains subject to the duty during the term of the reinsurance agreement and during the presentation of claims for payment. However, some precedent and commentary concerning reinsurance appears to adopt the view that "the failure of the claimant to disclose certain material reports after conclusion [formation] of the contract did not provide any remedy or right to the reinsurer to avoid the contract, although the assured was under a continuing duty not to make fraudulent claims." See CLYDE & CO 1.82, discussing *Manifest Shipping Co Ltd v Uni-Polaris (The Star Sea)* [2001] Lloyd's Rep IR 247 (House of Lords). See also STARING AND HANSELL § 10:6. Whether a post-formation breach of the duty of disclosure provides a remedy depends on the facts of the case such as the nature of the breach, its magnitude, whether the breach was intentional, and the degree of harm caused by the breach.

ARTICLE 2.1.2

(Duty of utmost good faith)

**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.**

COMMENTS

1. "Good faith" and "utmost good faith"

- C1. The duty of good faith and fair dealing set forth in Article 1.7 of the PICC applies to all commercial contracts. The Comments to Article 1.7 PICC mention the prohibition of an abuse of rights as well as the specific prohibition of inconsistent behavior set forth in Article 1.8 PICC to flow from the general good faith requirement. Several other provisions of the PICC also refer to good faith (cf. Article 1.7 PICC Comment 1). However, the PICC do not define good faith in general or give a list of applications of the principle. Different national jurisdictions use slightly differing nomenclature to describe the same essential concept and may differ regarding the type of conduct owed one another by contracting parties. But while some jurisdictions may have less stringent requirements of good faith, most generally view contractual obligations as containing a corresponding covenant of good faith and fair dealing. See, e.g., AMERICAN LAW INSTITUTE, *Restatement (Second) of the Law of Contracts* § 205 ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its

enforcement.”) and Comment (a)(“The phrase ‘good faith’ is used in a variety of contexts, and its meaning varies somewhat with the context. Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving ‘bad faith’ because they violate community standards of decency, fairness or reasonableness.”).

- C2. Article 2.1.2 applies the standard of “utmost” good faith to reinsurance contracts. This standard requires something more than the ordinary or “regular” good faith obligations prevailing in some jurisdictions for contracts that do not involve reinsurance or marine insurance. For example, in non-marine insurance matters in some jurisdictions (including most of the United States), an applicant or policyholder usually is required only to answer questions truthfully and generally need not volunteer adverse information unless this amounts to impermissible concealment. See STEMPEL, SWISHER & KNUTSEN at 478; STEMPEL & KNUTSEN §§ 3.07-3.11. However, a duty of “utmost” good faith requires the party seeking reinsurance cover to inform the reinsurer of all facts material to the risk, even if the reinsurer has not posed a specific question on that topic.
- C3. The term “*utmost* good faith” is one largely associated with English-speaking jurisdictions and is well-established regarding marine insurance and reinsurance in the United Kingdom and the United States, to some degree in nations that were formerly British colonies (e.g. India, Singapore). In other industrial nations, there appears to be a tendency to refer simply to “good faith” without use of the “utmost” modifier. See generally *IBA Report*, reviewing use of the term and the good faith standard in Argentina, Belgium, Brazil, China, Costa Rica, Denmark, France, Germany, Hungary, Italy, the Netherlands, Nigeria, Poland, Spain, Sweden, Switzerland, Thailand, and Turkey as well as in the UK, the US (States of California, Illinois, Massachusetts, New Jersey, New York, and Ohio), Australia, Canada, India, Ireland, Malaysia, Malta, and Singapore. In some jurisdictions eschewing the use of the “utmost” label, the prevailing concept of “good faith” requires conduct akin to that of countries with an utmost good faith standard (See, e.g., *IBA Report* at 23).

2. Insurance and reinsurance contracts distinguished from ordinary contracts

- C4. Although reinsurance agreements are contracts, like other insurance agreements, they have some distinct differences from what might be termed “ordinary” contracts. Unlike an ordinary contract, both insurance and reinsurance agreements are “aleatory” – meaning that the contract will not necessarily be one of equal exchange. For example, an insured or reinsured may pay premiums for decades and never have a loss or claim. The insured/reinsured pays substantial sums but never collects any funds or services in return. Conversely, an insurer or reinsurer may receive only a single premium and then be faced with a large loss or claim within weeks after inception of the policy, forcing the insurer/reinsurer to expend funds far in excess of the premium received.
- C5. The aleatory and uncertain nature of both insurance and reinsurance is the inevitable result of the fact that these contracts deal with risk and uncertainty. In return for a set premium or a share of the premiums collected by the reinsured, the reinsurer assumes the risk regarding the frequency and magnitude of covered matters. Because the

reinsurer faces such risks, the longstanding custom, practice, and law has been to require that a prospective reinsured make full disclosure of material information and data regarding risks so that the reinsurer can make an adequately informed decision whether to accept the risk and can set premiums accordingly as well as perhaps adding specific provisions to the resulting reinsurance agreement. See DORFMAN & CATHER at 169, 445; REJDA at 95 (“An insurance contract is based on the ***principle of utmost good faith*** – that is, a higher degree of honesty is imposed on both parties to an insurance contract than is imposed on parties to other contracts”)(boldface and italics in original). The duty of utmost good faith applies to both quantitative and qualitative information material to the risk.

3. The special circumstances of reinsurance that support imposition of a duty of utmost good faith

- C6. The nature of reinsurance provides a compelling case for imposing a duty of utmost good faith, which likely explains why jurisdictions that may not require this high a standard for primary insurance (e.g. the United States) require utmost good faith in the context of reinsurance. See *Travelers Indem Co v Scor Reinsurance Co*, 62 F3d 74, 76 (2d Cir 1995)(applying New York law)(“Reinsurers depend on ceding insurers to provide information concerning potential liability on the underlying policies.”); *Unigard Sec Ins Co, Inc v North River Ins Co*, 4 F3d 1049, 1054 (2d Cir 1993) (applying New York law) (“Historically, the reinsurance market has relied on a practice of utmost good faith to decrease monitoring costs and ex ante contracting costs ... [R]einsurers cannot duplicate the costly but necessary efforts of the primary insurer in evaluating risks and handling claims. ... They are protected, however, by a large area of common interest with ceding insurers and by the tradition of utmost good faith, particularly in the sharing of information.”).
- C7. Regardless of the differing treatment of non-marine insurance among jurisdictions, reinsurance agreements logically should be subject to the duty of utmost good faith and the PRICL expressly adopt this standard. Reinsurance underwriters tend to be considerably more removed from risks than non-marine insurance underwriters and are thus more dependent upon receiving adequate disclosure of material information from reinsureds. As a result, reinsurance law has long imposed more rigorous duties upon parties to a reinsurance agreement, particularly as respects the reinsured’s disclosure obligations, than are imposed upon insureds outside the context of marine insurance. The PRICL embrace the traditional view that because of the nature of reinsurance and the degree to which it differs from primary insurance, the reinsurer should be permitted to rely completely on the degree of material disclosure provided by the reinsured. Although the duty of utmost good faith is primarily stated in terms of duties of disclosure imposed upon a prospective reinsured, the duty applies throughout all aspects and stages of a reinsurance agreement. Although most discussion of the duty of utmost good faith in judicial decisions involves alleged breach by the reinsured, the duty is reciprocal and applies to reinsurers as well as reinsureds, even if the circumstances in which breach by the reinsurer is alleged may be comparatively less frequent than situations in which it is alleged that the reinsured failed to provide required information during the contracting process.

4. Features distinguishing “good faith” and “utmost good faith”

- C8. A distinguishing feature of the “utmost” good faith rather than what might be termed ordinary good faith is that the duty of utmost good faith can be breached when a marine insurance or reinsurance applicant is merely negligent in neglecting to inform the marine insurer or reinsurer about material information. By contrast, in some jurisdictions (most notably the United States), the duty of good faith applicable to ordinary insurance is considered fulfilled if questions are answered truthfully even though the respondent also has failed to provide information that it knows or should know is material to the risk involved.
- C9. Where the duty of utmost good faith attaches, the policyholder or reinsured shoulders a greater affirmative burden and must be proactive in informing the insurer or reinsurer rather than merely answering questions without deceit. As famously enunciated by Lord Mansfield,

Insurance is a contract upon speculation. The special facts upon which the contingent chance is to be computed lie most commonly in the knowledge of the insured only. The underwriter trusts to his [the insured’s] reputation, and proceeds upon confidence that he does not keep back any circumstances in his knowledge, to mislead the underwriter into a belief that the circumstance does not exist, and to induce him to estimate the *risqué* as if it did not exist. ... Although the suppression should happen through mistake, without any fraudulent intention, yet still the underwriter is deceived and the policy is void, because the *risqué* run is really different from the *risqué* understood and intended to be run at the time of the agreement ... Good faith forbids either party, by concealing what he privately knows, to draw the other into a bargain from his ignorance of that fact and his believing the contrary

Carter v Boehm, 3 Burr 1905, 1909 (1766).¹ *Accord*, *Rozanes v Bowen* [1928] 32 LI L Rep 98, 102 (Court of Appeals), in which it was held that the insured must make full disclosure “without being asked of all material circumstances because the underwriter knows nothing and the assured knows everything”; this duty is a hallmark of the utmost good faith principle. Similar requirements are set forth in the law of Australia (see Articles 12-14, Insurance Contracts Act; *Seaton v Heath*, 1 QB 782, 792 (1989), the prospective insured must disclose material facts affecting the risk), Canada (see 702535 *Ontario Inc v Lloyd’s London, Non-Marine Underwriters* (2000), 184 DLR (4th) 687 (ONCA)[702535]: the primary insurance contracts are subject to the duty of utmost good faith.), Ireland (see *Manor Park Homebuilders Ltd v AIRG Europe (Ireland) Ltd* [2009] 1 ILRM 190; in addition, in Ireland, all insurance contracts are subject to the duty of utmost good faith), Malaysia (see *National Ins Co Ltd v S Joseph* [1973] 2 MLJ

¹ The strong language used by Lord Mansfield was rendered in a decision involving insurance rather than reinsurance but has become widely cited to describe the duty of utmost good faith surrounding reinsurance. In addition, it should be remembered that despite this strong rhetoric, the court in *Carter v Boehm* ruled that the policyholder had not fallen short of the duty of utmost good faith. In particular, it was held not to be a breach of the duty when Roger Carter sought to purchase coverage for his East India Company’s factory at Fort Marlborough, Bencoolen, Sumatra for the period beginning October 1759 without expressly noting concerns over possible French privateering actions in the region. Those fears were realized during April 1760 when Fort Marlborough fell to the French. However, the holding of the case was that the insurer was in at least as good a position as Carter to assess the risk of French hostilities in that this risk was largely determined by international tensions in Europe where the insurer had equal or better access to relevant information than did the policyholder. See STEPHEN WATTERSON, *Carter v Boehm* (1766), Chapter 3 in Charles Mitchell & Paul Mitchell (eds), *Landmark Cases in the Law of Contract* (2016).

195; in Malaysia, all insurance contracts are subject to the duty of utmost good faith), and Singapore (see *IBA Report* at 131; Singapore follows English common law in applying the duty of utmost good faith to all insurance contracts). See generally HAN & PYNT.

Illustrations

- I1. A applies for facultative reinsurance for its program of excess insurance for a major pharmaceutical company. The company has given notice to A that the company has collected roughly 200 reports of adverse consumer reactions when using the drug and that local health authorities have commenced an investigation. A fails to share that information with B, the prospective reinsurer and a contract is formed in which B agrees to reinsure fifty percent (50%) of A's product liability coverage of the drugmaker. B never inquires as to whether A has knowledge of any problems regarding the drugs manufactured by A's policyholder. A has not made a misrepresentation to B because A has not made any false representations to B. According to the law of some jurisdictions, neither has A engaged in concealment. But A has violated the duty of utmost good faith by failing to disclose to B facts a reasonable reinsurer would want to know. A as an insurer should have known that this information would be deemed material by B and should have made disclosure without the necessity of a specific question. See Article 2.2.1 below regarding materiality.
 - I2. Same facts as Illustration 1 but the underlying drug company policyholder has told prospective Reinsured A of only two adverse reactions to the drug and there has been no hint of a government investigation. A's failure to disclose this information would probably not be deemed a breach of the duty of utmost good faith by most tribunals. For even perfectly safe and effective pharmaceuticals, there will be some adverse reactions. See AMERICAN LAW INSTITUTE, *Restatement of the Law (Third) Torts* § 402A, Comment (k), noting that some adverse reactions in a population are inevitable and providing that a prescription medicine is not defective or unreasonably dangerous simply because some users have such reactions. A mere two such cases would ordinarily not trigger prospective Reinsured A's duty to disclose. However, if prospective Reinsurer B specifically asked about adverse reactions, A would be required to answer truthfully and non-deceptively.
- C10. A further distinguishing feature of utmost good faith is that technically truthful but misleading responses constitute a breach.

Illustrations

- I3. Prospective Reinsurer B might ask prospective Reinsured A: "Did anyone call you about any risks not previously discussed?" The reinsured answers "No" and it is a technically correct answer because no one called the reinsured regarding this matter. But the reinsured had in fact itself made a call and during the call was informed about additional risks that were not disclosed to the reinsurer. Because the reinsured's answer is technically correct (it made the call but was not called), most jurisdictions in a case involving an ordinary

contract – and perhaps even an insurance contract – would find no fraud or misrepresentation and many would find no bad faith. However, this sort of tricky and literal answer evades the essence of the inquiry and clearly constitutes a failure to act in utmost good faith and would provide a basis for rescinding a contract.

- I4. As an example of an utmost good faith issue arising after contract formation, a reinsurer may suffer substantial losses with premium income it has invested. If information regarding these losses is not available through public sources of information and the losses pose a realistic threat of impairing the reinsurer's obligations to pay covered claims, the duty of utmost good faith would presumably require that the reinsurer disclose the losses and their implication to the reinsured. Reinsurance agreements often stipulate that the reinsurer is obligated to advise the reinsured of particular financial situations to ensure that the reinsured is sufficiently advised so that it can make informed decisions regarding its rights of cancellation. As an example, the Reinsurer might be required to notify the reinsured of a loss of a substantial amount of the reinsurer's surplus or capital. In the absence of specific language imposing such a requirement, it may nonetheless be found that disclosure of this sort is required by a duty of utmost good faith.

5. The touchstone of the concept of utmost good faith is honest and reasonable conduct in the context of the situation

- C11. Contract sources such as the commentary to the PICC and the *ALI Restatement* serve to flesh out the concept of good faith, as does case law and commentary. Statutory requirements applicable to insurance, such as consumer protection legislation or unfair claims practices statutes, may also provide guidance. For example, Comment (a) to § 205 of the *ALI Restatement (Second) of the Law of Contracts* states that good faith “emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party” and “excludes a variety of types of conduct” that are commonly characterized as bad faith “because they violate community standards of decency, fairness or reasonableness.” Comment (d) notes that “[s]ubterfuges and evasions violate the obligation of good faith in performance” and that the following have been “recognized in judicial decisions” as violating the duty of good faith: “evasion of the spirit of the bargain, lack of diligence and slacking off; willful rendering of imperfect performance, abuse of a power to specific terms, and interference with or failure to cooperate in the other party's performance.” Illustration 3 to Article 1.7 PICC provides another example focusing on the need for contracting parties to act reasonably.

A, an agent, undertakes on behalf of B, the principal, to promote the sale of B's goods in a given area. Under the contract A's right to compensation arises only after B's approval of the contracts procured by A. While B is free to decide whether or not to approve the contracts procured by A, a systematic and unjustified refusal to approve any contract procured by A would be against good faith.

Illustrations 2 and 4 to Article 1.7 PICC provide additional examples of behavior that fails to meet the good faith standard.

C12. Very generally, the duty of utmost good faith is often considered to operate as something of a “golden rule”, in which each party treats the other as it would itself want to be treated under the same circumstances. For example, if a reinsured fails to provide to the reinsurer information that the reinsured would have wanted had it been in the position of the reinsurer, the reinsured has breached the duty of utmost good faith. Conversely, where a reinsurer construes an underlying claim to present the least exposure possible and then argues that the reinsured has overpaid, the former breaches the duty of utmost good faith by failing to give the reinsured the reasonable benefit of the doubt.

6. The duty of utmost good faith imposes core requirements of disclosure, particularly upon the prospective reinsured

C13. Applied to the reinsured in the contract solicitation process, the duty of utmost good faith “requires the reinsured to disclose all facts that are material to the risks being ceded, even if the reinsurer has not inquired about those risks”. See COHEN, DEMASSI & KRAUSS at 603; *Accord, IBA Report*.

C14. However, the right of a reinsurer to receive information regarding material developments affecting the reinsurance agreement is limited to information that is actually known by the reinsured or which should have been known to a reinsured meeting the industry standard of care for reasonable diligence. The reinsured is not required to be omniscient or clairvoyant in its ability to foresee emerging risks and predict outcomes. However, the reinsured is charged with having an appreciation of the information material to the reinsurer that would be apparent to a reasonable reinsured purchasing reinsurance of the type sought.

Illustrations

15. Prospective Reinsured A is a commercial property insurer that does business nationally across the United States and has a high concentration of its policies along the Gulf Coast (which is prone to hurricanes). A fails to apprise prospective Reinsurer B of the geographic concentration of its business and risks. In the absence of disclosure or facts otherwise known (e.g. that A’s headquarters are in Houston, Texas and that ninety percent (90%) of its employees are in Texas, Louisiana, and Florida - all areas prone to hurricanes), B could reasonably assume that A’s risk pool is relatively evenly distributed across the US and therefore not at any undue risk of hurricane claims. But the opposite is true in view of the concentrated nature of A’s risk pool. Failure to disclose this concentration of its business by Reinsured A is a breach of the duty of utmost good faith.

16. Prospective Reinsured A writes residential property insurance and has ninety percent (90%) of its business in North Carolina, South Carolina, Florida, Alabama, Mississippi and Louisiana – all of which is disclosed to prospective Reinsurer B. However, A does not inform B that A’s property loss policies do not contain exclusions for flooding or other water damage such as hurricane storm surge. Even if B does not ask about policy content as part of its underwriting process, B is entitled to know that A is issuing such unusually

broad water damage coverage in a region with much higher flood and water damage risk than most areas. A's failure to make this disclosure violates A's duty of utmost good faith.

17. Norway-based Reinsured A has a heavy concentration of property damage policies insuring buildings in Scandinavia. Swiss Reinsurer B contracts to provide proportional reinsurance on the risk. An unusually cold and stormy winter creates much larger seasonal losses than usual throughout Northern Europe. A's failure to specifically note the portion of its risks in Scandinavia is not a violation of the duty of utmost good faith. B should have reasonably assumed that a Norwegian reinsured would have substantial exposure to Scandinavian risks and that harsh winters are a risk consistently facing Northern Europe.

7. Materiality of information

- C15. What constitutes material information may vary according to the type of risk reinsured. For example, a life reinsurer will be concerned about the quality of the reinsured's underlying policies and its underwriting guidelines and procedures. By contrast, a property or casualty reinsurer will be more concerned about the location of the reinsured's risk and the magnitude of the exposure created by the policyholder's activities.

Illustrations

18. Reinsured A, which has a portfolio of commercial liability policies covering a chain of storage facilities, contracts with Reinsurer B but fails to inform the reinsurer that the facilities contain large quantities of propane gas. One of the tanks explodes, setting off a chain reaction that engulfs the local area in fire, causing extensive damage. A's failure to disclose the dangerous contents is a material omission that violates the duty of utmost good faith. B may avail itself of the remedies provided in Chapter 3 of the PRICL. See, e.g., *Security Mutual Casualty Co v Affiliated FM Ins Co*, 471 F2d 238, 241 (8th Cir 1972)(applying Minnesota law)(failure to inform the reinsurer that the tenant of the building covered by property reinsurance used highly flammable liquids for leatherworking is a material omission violating the duty of utmost good faith even if the omission is not the product of fraudulent intent).
19. Reinsured A contracts with Reinsurer B regarding liability insurance for an insured with the nondescript name of "Generation X," which is described as a "manufacturer." Generation X operates electric power generation plants. After inception of the contract, Generation X is sued in connection with contamination claims relating to its coal-fired and nuclear power plants. Because B could have researched the business of the insured, B's attempt to avoid coverage or rescind the policy may fail on the ground that in the exercise of reasonable care B should have known of the risks posed. However, most tribunals would regard the specific activity of A's policyholder and the heightened risk it presented as material, which would make A's failure to disclose a breach of the duty of utmost good faith. See, e.g., *Sumitomo Marine*

& Fire Ins Co v Cologne Reinsurance Co, 552 NE2d 139 (NY 1990)(failure of the reinsured to disclose that its policy for the steel mill covered radioactive contamination loss was material and violated the duty of utmost good faith). The presence or absence of pollution or nuclear waste exclusion in A's policies and their enforceability and application under the applicable law may also be a relevant factor in assessing whether A's non-disclosure was material or a violation of its duty to B and certainly would impact the amount of coverage owed and any damages suffered by B.

- I10. Reinsured A provides general liability insurance to a major manufacturer of automobiles. A informs Reinsurer B of the identity of the manufacturer and the policies but does not specifically inform B that the automaker also manufactures ATVs (All-Terrain Vehicles) that are used for recreational riding off-road. ATVs constitute one percent of the manufacturer's business. After a contract is formed, B seeks to rescind because of a larger than expected number of claims alleging defective design of the ATVs because riders have suffered serious rollover injuries while riding off-road. A's non-disclosure regarding ATVs would not be regarded as a material omission by most tribunals. See *Christiana General Ins Corp v Great American Ins Co*, 979 F2d 268, 279-80 (2d Cir 1992)(applying New York law), affirming 745 F Supp 150 (SDNY 1990)(noting the existence of the duty of utmost good faith in reinsurance but finding that the reinsured's failure to disclose that it covered Honda ATVs as well as Honda automobiles was not material. See also STARING AND HANSELL § 10:3 (collecting cases involving non-disclosure, materiality, and judicial determinations of whether the duty of utmost good faith was breached).
- I11. Same facts as above but ATVs constitute 10 percent of the manufacturer's vehicles insured by A. This greater exposure to ATV claims is material if the facts show that ATVs present a sufficiently heightened liability risk in light of the greater proportion of ATVs in the reinsured fleet. The omission of the information would then likely be deemed material and be considered a breach of A's duty of utmost good faith in disclosure.
- I12. Same facts as the Illustration above but B asks A about the number of automobiles, trucks, and motorcycles sold each year without making any inquiries whatsoever about ATVs or off-road vehicles generally. A answers truthfully but makes no disclosure about ATVs. Because B has indicated interest in the composition of the fleet of vehicles insured by A, B has shown that it considers the type of vehicles sold an important fact. A's failure to mention ATVs when providing other specific details of the fleet suggests a breach of the duty of good faith and that A's failure to mention ATVs – which may have a relatively higher incidence of claims – is a material omission that violated A's duty of utmost good faith.
- I13. *Other Illustrations*: The following cases provide useful examples of omitted material information that should have been disclosed to the reinsurer during the contracting process. See, e.g., *Sun Mutual Ins Co v Ocean Ins Co*, 107 US 485 (1883)(failure to disclose other applicable insurance is a material omission violating the duty of utmost good faith); *M'Lanahan v Universal Ins Co*, 26 US

170 (1928)(failure to provide date of the vessel's sailing is a material omission violating the duty of utmost good faith); *Carlingford Australia Gen'l Ins Ltd v St. Paul Fire & Marine Ins Co*, 722 F Supp 48 (SDNY 1989)(reinsured's failure to inform reinsurer of an arrangement that guaranteed profit and removed or lessened the incentive to investigate claims was a material omission violating the duty of utmost good faith).

8. The duty of utmost good faith applicable to reinsurance contract performance is not burdensome

- C16. The fact that the duty of utmost good faith applies throughout the contract and not solely to pre-contract negotiations does not mean that the reinsured is required to continually provide the reinsurer with updates on all information that was required to be disclosed as part of contract formation. Once a contract is formed, risk has been transferred and allocated among the parties and the reinsurer, having accepted that risk, is bound to pay covered claims absent a valid defense. For treaty reinsurance in particular (as contrasted to facultative reinsurance that is specifically underwritten), it would not be practical to expect an ongoing duty of providing information as extensive as that attending contract formation. However, when a facultative certificate or treaty obligation is subject to renewal, the reinsured is required to provide material information to the reinsurer in a manner equivalent to the duty placed upon the reinsured during the initial negotiation and formation of the contract. In addition to providing updates concerning material factual information, a reinsured seeking renewal should also provide information regarding material changes to the legal environment. The reinsured should generally also notify the reinsurer of any changes in the underlying business of the reinsured, such as changes in underwriting policy or claims management policy.

Illustrations

- I14. Reinsured A and Reinsurer B are approaching the renewal date of the contract. A becomes aware that a recently developed product of its policyholder that has just entered the market has been discovered to have a deadly defect that was not known at the time of the placement of reinsurance. The policyholder has shipped roughly 10,000 of these products to retailers or consumers. Although there is concern, the product is not subject to government or manufacturer recall. The information is material and should be disclosed by A to B prior to renewal of the contract. A's failure to disclose would violate the duty of utmost good faith and entitle B to pursue the remedies provided in Chapter 3.
- I15. Reinsured A has an extensive portfolio of homeowner policies in Canada. Meteorologists predict a particular cold winter for the region. A becomes aware of this in September, just before the 1 October renewal of the contract. This prediction of a colder winter in the area does not impose a duty of disclosure upon A, even though it might mean more claims for losses due to frozen pipes during the ensuring period after renewal. Although a colder winter may significantly affect claims, relatively colder or warmer weather occur in the normal course of business and do not constitute the sort of material development that must be disclosed to the reinsurer. It would not substantially

increase the risk that the reinsurer has already accepted. B already knows that A sells property insurance in a cold weather climate where frozen pipes and similar losses are normal. B is also aware that some winters are harsher than others and that Canadian winters are on average harsher than those in most other countries. Further, the predicted colder winter may not come to pass. Even if it does, this is not certain to lead to substantially more frequent or severe claims. This distinguishes information of this type from information such as an anticipated surge in claims due to design defect in a product.

- I16. Reinsured A, a general liability insurer, contracts with Reinsurer B at a time when the amount of “non-economic” damages or “pain and suffering” damages were limited to USD 250,000 in the state where A has almost all of its exposure. During the term of the policy, the state legislature increases the damages cap to USD 1 million. The contract is up for renewal. A does not advise B of the change in the law. Reinsured A has violated the duty of utmost good faith by failing to inform Reinsurer B of this change in the law that increases the exposure of the Reinsured and hence increases the exposure of the reinsurer.
- I17. Same facts as in no. 16 but the state in which A has its policies of insurance has clear state supreme court precedent that bars punitive damages against automobile policyholders, no matter how reckless the driving or other misconduct of the driver and A is an automobile liability insurer. This anti-punitive damages precedent is overruled during the period of the contract. The contract becomes subject to renewal. A does not advise B of the change in the law. This failure to disclose is a material omission. Information of this importance should be transmitted by the reinsured to the reinsurer, particularly if A and B are in different countries or continents, notwithstanding the broad electronic availability of information about the law. Excusing A from a duty to inform B of this change in the law would have the practical effect of increasing the reinsurer’s cost of doing business, because it now must devote greater resources to monitoring legal developments in the countries or states in which it reinsures. This additional expense logically leads to higher reinsurance premiums and a net social loss that could have been avoided if A – which already knew about the change in law – were required to inform B prior to entry into a renewal of the contract.
- I18. Reinsured A and Reinsurer B have contracted for reinsurance for A’s portfolio of life insurance. The statute of limitations on life insurance claims in A’s jurisdiction of operations is four years; the limitations period generally applies to breach of contract claims. A period of war drove many immigrants from a war-torn country to A’s jurisdiction, where the immigrant community has become well-established and now seeks to pursue recovery of life insurance benefits owed to them as beneficiaries of their dead relatives, many of whom had purchased life insurance from A. The claims would otherwise be barred by the statute of limitations, but the jurisdiction’s legislature extends the statute of limitations. Seeing an unexpected upsurge in life insurance claims, B argues that the principle of utmost good faith required that this information be transmitted from A to B and that A’s failure to disclose the extended statute of

limitations constitutes a breach of the duty of utmost good faith. Most tribunals would regard this argument as unpersuasive notwithstanding the unusual circumstances. B is considered roughly as capable of monitoring changes in the law during the period of the contract as is A. The crucial distinction between this Illustration and the two prior Illustrations is that in the prior Illustrations, the reinsurance was up for renewal, a time at which the reinsurer has the opportunity to avoid assuming continued risk and during which the reinsurer should be adequately informed of material changes in risk. By contrast, when there are changes in the law during the period of the contract, this is ordinarily a risk assumed by the reinsurer.

9. The duty of utmost good faith requires candor by the parties in their representations and responses to one another

C17. Where either party propounds clear and precise questions to the other in respect of information material to the inquiring party, the party receiving the inquiry has a duty to answer fully and truthfully based on the circumstances of which the party is aware or should be aware if exercising reasonable care in its response.

10. The role of the duty of utmost good faith is heightened during the contract formation period

C18. Prior to formation of the contract, a material non-disclosure or misrepresentation may support the remedy of avoidance of the agreement where this constitutes a “fundamental” breach as outlined in Article 3.2 paragraph (3). After formation, non-disclosure of material facts violates the duty of utmost good faith but may be less likely to justify abrogation of the agreement. Situations of this sort, even more than contract questions generally, are subject to the principle that breach of contract should not result in disproportionate forfeiture (see the remedies provided in Article 3.1). Avoidance of a reinsurance agreement that has been in effect for years and which has been relied upon by the parties would appear to be too great a penalty for failure to disclose even important developments affecting the risk. But the reinsured should nonetheless apprise the reinsurer of material matters so that the reinsurer is better able to plan ahead regarding ongoing and future claims.

11. Consent provisions in a reinsurance contract are subject to the duty of utmost good faith and must be reasonably exercised

C19. Where a contract prohibits settlement or payment by the reinsured without the reinsurer’s consent, the duty of utmost good faith requires that the reinsured shall abide by such provision unless the reinsurer’s consent is unreasonably withheld, which would be a breach of the duty of utmost good faith by the reinsurer. To the extent that a reinsurer’s refusal to consent causes injury to the reinsured, the reinsured may have a right to compensation from the reinsurer. The reinsured logically bears the burden of proof to show that the reinsurer’s refusal was unjustified.

C20. However, the reinsurer is required to exercise any such powers of consent reasonably. It would violate the reinsurer’s duty of good faith for the reinsurer to exercise its rights of consent in a manner that unfairly favors the reinsurer’s interest (e.g. attempting to delay

payment in order to serve investment or business objectives, even though this imposes hardship on the reinsured) or deprives the reinsured of the benefit of the bargain made by the reinsurance agreement.

- C21. As a means of modifying the default rule of follow-the-fortunes and follow-the-settlements (addressed in Article 2.4.2 PRICL below), the reinsurance agreement may provide that the reinsurer's consent is required as a condition of settlement payment. Similarly, the reinsurance agreement may give the reinsurer a right to review and exercise veto power over decisions to refuse settlement offers or to take or refrain from actions such as filing post-trial motions or pursuing an appeal of an adverse judgment.
- C22. Ordinarily, a reinsurer is not responsible for extra-contractual liability to the insured occasioned by misconduct of the reinsured (e.g. bad faith conduct, statutory violations, wrongdoing by the reinsured independent of the contract obligations between reinsured and insured). But where the reinsurer's unreasonable withholding of consent causes injury to the reinsured, the reinsurer is responsible for compensating the reinsured.
- C23. Where a reinsured is presented with a claim that the reinsured regards as within coverage and sufficiently meritorious to merit payment but the reinsurer unreasonably refuses consent to payment, the reinsured should be permitted to pay the claim without prejudice to the reinsured's rights to collect reinsurance payments, notwithstanding that the reinsured in such a situation paid a claim in spite of the reinsurer's refusal to consent.

Illustration

- I19. Reinsured A has a policyholder facing a catastrophic injury claim. The plaintiff suing A's policyholder offers to settle the claim in return for payment of the USD 500,000 policy limits of A's automobile policy. The settlement demand appears reasonable. A would like to accept plaintiff's offer; Reinsurer B refuses to consent to the proposed settlement. Trial of the unsettled case results in a USD 3 million judgment against A's policyholder. Pursuant to the "excess judgment" rule prevailing in the United States, A as an insurer will be held responsible for not only paying its policy limits but also for the additional USD 2.5 million judgment. If A can demonstrate that its erroneous refusal to settle was caused by B's withholding of consent, B may be required to pay the excess judgment claim, reimburse A for payment of the excess judgment, or share liability for the excess judgment with A. In the event that A and B are both at roughly equal fault for failing to make a reasonable settlement decision, their respective liability would be controlled by their proportional responsibility for losses as set forth in the contract.

- 12. Active administration of a claim by a reinsurer may make the reinsurer liable to the same extent as the reinsured that is administering the claim in first instance. Depending on local applicable law, the reinsurer may also be directly liable to the reinsured's policyholder.**

- C24. Although a reinsurer is entitled to be kept informed regarding claims and to require its consent to resolution and payment of claims, the reinsurer shall ordinarily refrain from

active involvement in the resolution of a claim. Where the reinsurer becomes actively involved in the resolution of any of the reinsured's claims subject to the reinsurance, the reinsurer does so with knowledge that this may subject the reinsurer to the legal regime governing the reinsured in the jurisdiction in which a claim is adjudicated.

- C25. Ordinarily, there is no privity of contract between a plaintiff suing a reinsured's policyholder – or between the policyholder and the reinsurer. So long as the reinsurer is not involved in the claims process, any contract or tort rights of plaintiff or policyholder are limited to actions against the policyholder or reinsured. However, to the extent that the reinsurer becomes involved in the reinsured's claims handling beyond merely exercising rights of consent, the reinsurer is now operating as if it were the reinsured. Under these circumstances, the rights of a plaintiff or policyholder vis-à-vis the reinsured would also apply to the reinsurer.
- C26. Where a reinsurer becomes closely involved with a reinsured's claims decisions that are later found to create coverage liability or extra-contractual liability to the insured, the reinsurer may properly be held responsible for its contribution to the reinsured's misconduct and share the reinsured's liability to the insured.

Illustration

- I20. Reinsured A is sued by a policyholder seeking payment policy limits when the policyholder's factory is totally destroyed in a fire. A has concerns about the claim and consults Reinsurer B. B examines the file and concludes that the loss was probably the result of arson by the policyholder and instructs A not to pay the claim and that if A does so, B will refuse to pay its proportionate reinsurer's share. B, which claims great expertise in arson defenses to property loss claims, provides co-counsel to A in defending the claim and insists that A make certain motions and conduct particular discovery designed to defeat the claim. A concludes the loss was not the result of arson, becomes uncomfortable with the aggressive nature of the defense, and seeks to settle the claim. B refuses to consent and again threatens A with loss of reinsurance cover if A deviates from the strategy and tactics outlined by B. The case proceeds to trial, with the policyholder prevailing on its policy limits breach of contract claim, the state's Unfair Claims Practices Act, and common law bad faith, including an award of punitive damages. Because B so heavily inserted itself into the claims process, B must at least share proportionately in A's liability. See, e.g., *Peerless Ins Co v Inland Mutual Ins Co*, 251 F2d 696 (4th Cir 1958) (applying West Virginia law) (reinsurer involved in underlying litigation and settlement decisions may be held responsible for those decisions in bad faith action by reinsured's policyholder).

13. A party asserting breach of the duty of utmost good faith bears the burden of proof on the issue

- C27. Where there is a dispute regarding whether the duty of utmost good faith has been breached, the burden of proof or burden of persuasion to demonstrate breach rests with the party asserting breach.

Illustration

- I21. Reinsurer A contends that Reinsured B has failed to disclose facts material to the risk assumed by the reinsurer and seeks rescission. Specifically, A contends that B's failure to advise A of demand letters from product users of B's insureds constitutes a failure to provide material information. A must demonstrate that the missing information was material to the risk assumed by the reinsurer and should have been disclosed. In other words, A must show that the type of injuries alleged due to use of the product of B's insured and the volume of complaints are the types of information that would have affected A's decision to enter into the contract. A also has this burden of persuasion even if it is seeking a less drastic remedy, such as an increase in premium payment (rather than avoidance), to compensate for the alleged higher risk it assume.

ARTICLE 2.1.3*(Confidentiality)*

The parties shall treat information provided one another as confidential. Absent permission, they shall not disclose it to third parties except where required by law and except as necessary to provide information to professional advisers, statutory auditors, regulatory authorities and retrocessionaires.

COMMENTS

- 1. Reinsureds and reinsurers should take adequate care to avoid unauthorized disclosure of sensitive information to third parties**
- C1. Because the reinsurance agreement is one of utmost good faith, parties to the agreement must take reasonable care to avoid disclosure to third parties of the information obtained pursuant to the relationship.

Illustrations

- I1. Through the contracting process, Reinsured A becomes aware that Reinsurer B has been accused of sexual harassment by employees of a particular office. Reinsured A should not be disclosing the information, even if there is pending litigation that is not sealed but is not generally known.
- I2. Reinsurer B discovers from the contracting process that Reinsured A has been losing market share in an important jurisdiction and that it is planning on terminating an advertising campaign that it has deemed unsuccessful. Even though not important to the reinsurance contract between A and B, the information is confidential and should not be disclosed by B.

2. The breadth of confidentiality

- C2. Of particular importance is the protection of the intellectual property and trade or business secrets of the parties. Intellectual property includes contract language, customer information, and databases used by the parties; it is not limited to inventions of machinery, software, and similar products.

Illustrations

- I3. Reinsurer B develops a particular structure for reinsuring risks that is unique to the contract or an innovation by the reinsurer. Reinsured A and its agents should not share this information with others, particularly competitors of the reinsurer.
- I4. Reinsured A develops unique policy language narrowly tailored to eliminate a particularly vexing risk without undermining the overall breadth of the general liability coverage it writes and has made this product available only to particular customers. This product design is the intellectual property of A and if treated as confidential by A should not be disclosed by B. However, if A uses the design of the policy in its general marketing efforts, the information is no longer confidential.
- C3. The parties shall not disclose any preferential treatment provided in the contract that is not extended to other insurers or reinsurers.
- C4. The protection of confidentiality should not be so broadly construed as to prevent effective business communication for placing risks.
- C5. This provision of the PRICL is not designed to prohibit use of information in the ordinary course of seeking to convince additional reinsurers to subscribe to a risk. This practice is common and ordinarily should be considered implicitly authorized when a reinsured is purchasing coverage from more than one reinsurer. Of necessity, all reinsurers considering acceptance of the risk will need to see the reinsured's underlying information. But Reinsurer B should not be allowed to see information provided to Reinsured A by Reinsurer C beyond what is necessary to permit Reinsurer B to assess the risk and determine whether to participate.
- C6. Parties to a reinsurance contract are free to provide their own specific rules regarding use of information. Because the PRICL provides a set of default rules, the parties to a reinsurance contract may establish their own rules of disclosure. Such situation-specific agreement is common, with many or perhaps most reinsurance agreements also containing a Non-Disclosure Agreement ("NDA") agreed upon by the parties. Examples of such NDAs are attached to the PRICL as Appendix C.
- C7. The Duty of Confidentiality is subject to reasonable exceptions. For example, a party to a reinsurance contract may make disclosures to third parties where required by law. The duty of confidentiality is not an evidentiary privilege that prevents legitimate inquiry by authorized regulators or officials with supervisory authority. In addition, notwithstanding the duty of confidentiality, reinsureds and reinsurers logically must be

permitted to disclose information required by professional advisers, statutory auditors, regulatory authorities and retrocessionaires.

ARTICLE 2.1.4

(Good faith in dispute resolution)

The parties shall make reasonable and diligent efforts to resolve disputes arising pursuant to the contract as expeditiously and efficiently as possible.

COMMENTS

1. The duty of utmost good faith is ongoing and continues into and throughout the dispute resolution process

C1. Disputes inevitably arise in commercial relationships, particularly when commercial actors are involved in long-term contracts and business relationships. Logically, the duty of utmost good faith that attends the reinsurance relationship extends throughout the duration of the relation, including periods when the parties are in dispute. Although an adversary proceeding, such as arbitration or litigation, may place the parties at odds, their duties to one another remain and they must continue to conduct themselves accordingly.

2. Utmost good faith in the dispute resolution process requires that the parties refrain from engaging in opportunistic behavior

C2. Depending on the circumstances of the dispute, one of the parties may have greater incentive to delay, extend, or multiply the proceedings in order to gain commercial advantage. The duty of utmost good faith requires that disputing parties refrain from opportunistic behavior.

3. Opportunistic behavior is conduct that deprives another party of the benefit of the bargain by making it unduly difficult to resolve contractual disputes expeditiously and with a minimum investment of resources

C3. A contract party acting in utmost good faith raises only legitimate issues, rather than manufacturing issues or arguments in an attempt to avoid contract obligations or delay its performance of contract obligations. Similarly, a contracting party disputing in good faith refrains from delaying or diversionary tactics.

C4. Although parties to an ordinary contract are not fiduciaries to one another and may reap the fruits of an informational advantage, the duty of utmost good faith requires greater candor and limits a party's ability to exploit information asymmetry. For even ordinary contracts accompanied by a minimal duty of good faith, one cannot take deliberate advantage of an oversight by a contract partner concerning his rights under the contract.

Such taking advantage is not the exploitation of superior knowledge or the avoidance of unbargained-for expense; it is sharp dealing. Like theft, it has no social product, and also

like theft it induces costly defensive expenditures in the form of over-elaborate disclaimers or investigations into the trustworthiness of a prospective contract partner, just as the prospect of theft induces expenditures on locks.... [C]ontracts do not just allocate risk. They also ... set in motion a cooperative enterprise, which may to some extent place one party at the other's mercy. ... The office of the doctrine of good faith is to forbid the kinds of opportunistic behavior that a mutually dependent, cooperative relationship might enable in the absence of the rule. ... The contractual duty of good faith is thus not some newfangled bit of welfare-state paternalism or the sediment of an altruistic strain in contract law, and we are therefore not surprised to find the essentials of the modern doctrine well established in nineteenth-century cases.

See *Market Street Associates v Frey*, 941 F2d 588, 594-95 (7th Cir 1991)(Posner, J)(applying Wisconsin law).

- C5. The reciprocal duties of a reinsured and reinsurer are broader and more demanding than those of ordinary contracting parties, as reflected by the “utmost good faith” terminology attached to the duty.

Illustrations

- I1. Reinsured A, after properly notifying Reinsurer B and keeping it informed of the situation, defends its policyholder, a Silicon Valley start-up against allegations of gender discrimination by a female worker. Trial results in a multi-million judgment because a manager's behavior has been particularly crude. Three other women workers at the company have similar claims involving the same disagreeably harassing manager. A settles the claims, paying several hundred thousand dollars to each of the plaintiffs. B, which knew of the planned settlements and did not protest, now refuses to reimburse A, alleging that the settlements were unreasonably high. B in fact understands that A's settlement decisions were reasonable under the circumstances but is resisting payment both to delay payment and in hopes that it can get A to absorb a higher share of the cost than provided in the reinsurance contract. B's conduct breaches the duty of utmost good faith.
- I2. Reinsured A seeks payment from Reinsurer B for A's payments in connection with a large portfolio of automobile liability claims. B resists on several very weak grounds because it has favorable investments and profits from delay in payment. In addition to raising meritless defenses to payment, B rejects all of A's suggestions regarding choice of arbitrators, forcing A to seek a determination by the arbitral tribunal, causing further delay. Then B rejects the proffered dates for a hearing on the matter, even though B can accommodate the tribunal's suggested hearing dates. B has breached the duty of utmost good faith.

4. **The rules of proper litigation and arbitration conduct provide a minimum threshold that must be met by reinsurance disputants. However, if the duty of utmost good faith is to have meaning, certain sharp practices that may be permitted between strangers or other contracting parties should not be pursued in reinsurance contract disputes**
- C6. The rules of tribunals, courts in particular, provide a series of benchmarks as to what constitutes unacceptable disputing behavior. See, e.g., 28 USC § 1927 (party that vexatiously delays or multiplies litigation may be sanctioned; US Fed R Civ P 11 (providing for sanctions if counsel or a party makes claims without legal or evidentiary support or solely to disrupt opposing parties). But because litigation is inherently adversarial, particularly in the US and the UK where judges are expected to act more as referees rather than active investigators, tactics that might be considered excessive in social or business settings may be tolerated – at least where the disputants are strangers (e.g. tort litigation) or have only an arm’s-length and competitive business relationship. By contrast, a reinsured and a reinsurer are involved in a more cooperative, collaborative, ongoing relationship where they are expected to work together subject to the duty of utmost good faith. As consequence of these differences from other dispute resolution settings, a higher level of conduct is expected between a reinsured and reinsurer.

Illustrations

- I3. Reinsurer B is reluctant to pay Reinsured A until it is provided with additional claim data in view of the many large settlements agreed to by A during the contract period. A refuses even though the contract clearly gives B broad inspection rights. A has no factual or legal basis for its refusal. A has breached its duty of utmost good faith.
- I4. Same facts as above except that A agrees to permit inspection – provided that B sends someone from its office in Zurich to a small town in Alaska where A collected the documents after the dispute arose. A refuses to provide the documents in electronic form or to otherwise make copies. The location of A’s document depository was chosen precisely because it was remote. A hoped that it would discourage inspection and also expected that requiring such on-site inspection would make it more likely that B’s counsel would miss important information in the documents. A has breached the duty of utmost good faith.

SECTION 2: PRECONTRACTUAL DUTY OF THE REINSURED

ARTICLE 2.2.1

(Duty of disclosure by prospective reinsured)

In seeking reinsurance cover, a prospective reinsured shall provide the reinsurer with all information of which it is or reasonably ought to be aware and which is material to the risks to be assumed by the reinsurer. Information is material to a risk if

the information is of the type that would affect a reasonable and prudent reinsurer's decision as to whether to accept the risk and if so under which terms and conditions and for which premium.

COMMENTS

- 1. The duty of utmost good faith logically requires a prospective reinsured or a reinsured seeking renewal of a reinsurance contract to provide disclosure of information material to the risks covered by the contract**
- C1. A logical corollary to the duty of utmost good faith is the obligation of a prospective reinsured to disclose to the prospective reinsurer all known information material to the risk. The focus in determining materiality is that of a reasonable party to the transaction. Information is material if it would affect the reasonable party's decisions regarding the contract and was in fact material to the party in question.
- 2. The disclosure duty does not extend to information already known to the other party**
- C2. A reinsured's obligation of disclosure does not require it to disclose information of which the reinsurer is already aware or that the reinsured would ordinarily expect the reinsurer to know. See *Compagnie de Reassurance d'Ile de France v New England Reins Corp*, 57 F3d 56, 80 (1st Cir), *cert denied*, 516 US 1009 (1995)(applying Massachusetts law)("courts recognize that the insured need not disclose 'what the insurer already knows or ought to know'"); *Puritan Ins Co v Eagle SS Co, SA*, 779 F2d 866, 871 (2d Cir 1985)(applying New York law)(the reinsured is not obligated to make "minute disclosure of every material circumstance"); *Sumitomo Marine & Fire Ins Co v Cologne Reins Co of Am*, 75 NY2d 295, 330 (NY 1990)(the "reinsured ordinarily has no obligation to disclose the terms upon which insurance has been granted where those terms are generally found in policies of that nature, for the reinsurer ought to be aware of such standard terms."). However, the duty of utmost good faith suggests that in seeking reinsurance, the prospective reinsured may be reasonably expected to ask the reinsurer what type of information is of interest to the reinsurer. This potential obligation needs to be seen in the context of the reinsured's professional experience and knowledge.

Illustration

- II. Reinsured A is a small local insurance company operating exclusively in one state. Although not incompetent, it lacks the resources and expertise of a large international insurance group. A large percentage of A's business is crop insurance. A is aware that a devastating disease is affecting state farmers and is likely to cause large crop losses. A fails to inform Reinsurer B when A enters into a reinsurance contract with B. Notwithstanding its small size and comparatively meagre resources and sophistication, A has breached its duty of disclosure and utmost good faith by failing to inform B of the crop disease.

3. The inquiry in determining materiality is whether the information in question affects risk; whether the undisclosed information relates to the loss or claim at issue is not relevant

- C3. A prospective reinsured may fail to disclose or misstate information that is quite central to the risks embraced by the reinsurance contract, obtain renewal, and then make a demand for reimbursement of claims paid in connection to losses that are not affected by the undisclosed information. The reinsured may argue that this omission or misrepresentation is not material in that the loss and the omission or misrepresentation are not connected to the cause of loss. Such an argument is incorrect and unpersuasive. The omitted information is material, because it was relevant to the risk in that it affected the reinsurer's determination of whether to enter into or renew a contract. The fact that the actual loss was unrelated to the non-disclosure does not change the fact that but for the non-disclosure there would probably have been no reinsurance contract upon which to make a claim for the loss paid. The nature of the loss in relation to any non-disclosure or misrepresentation made by a prospective reinsured may be relevant to whether the reinsurance contract may be avoided, whether the loss claims are covered in whole or part or whether another remedy is apt pursuant to Article 3.2. But the fact remains that there has been material non-disclosure if the non-disclosure relates to the risks presented by the contract, regardless of the particularities of any ensuing loss.

Illustration

- I2. Prospective Reinsured A, a life insurer, fails to inform the prospective Reinsurer B that it sells policies exclusively through marketing to members of the American Association of Retired Persons (AARP). The minimum age for AARP membership is 55. Forty of the policyholders are killed when a terrorist bomb destroys the high-rise apartment building in which they reside. All held high-limit life insurance policies issued by the reinsured, resulting in payments of USD 40 million by the life insurer/reinsured to beneficiaries. Reinsurer B discovers the failure to disclose the age information at which policies were targeted, a material omission in view of the increased mortality associated with age. An objectively reasonable and prudent reinsurer would have demanded a higher premium as a condition of entering into the reinsurance contract. Reinsured A nonetheless seeks payment by the reinsurer by arguing that the deaths of the insured persons were not related to their age but were caused by murder. Although A is correct that the loss in question was caused by terrorism and crime rather than age-related mortality, A's non-disclosure is nonetheless a material omission that entitles the reinsurer to a remedy as provided in Article 3.2.

4. Material information is that which would influence a reasonably prudent reinsurer's decision regarding whether to enter into the contract or the premium to be charged

- C4. The touchstone of materiality is whether the undisclosed information, if known, would have affected the behavior of the reinsurer, in particular whether the reinsurer would have refused to enter into the reinsurance contract or would have charged more because of the impact of the omitted information upon the risks assumed in the contract. For

example, a reinsurer, had it known all the facts, may have refused to accept the risk. Or the reinsurer may have been willing to accept the risk only if it received a larger premium or modified the contract in other ways such as with a specific exclusion or limitations upon certain risks. See AMERICAN LAW INSTITUTE, *Restatement of the Law, Liability Insurance* § 8 (Proposed Final Draft 18 April 2018)(approved at ALI Annual Meeting, May 2019) (misrepresentation material “only if, but for the misrepresentation, a reasonable insurer in this insurer’s position would not have issued the policy or would have issued the policy only under substantially different terms”). Determining materiality is based upon the reaction of the objectively reasonable and prudent reinsurer rather than the idiosyncrasies of any particular reinsurer. See STARING AND HANSELL § 10:3[5] (collecting US and UK cases on materiality). Materiality thus has a subjective component (i.e., what would this particular insurer have done if adequately informed) and an objective component (i.e., would proper disclosure have changed a reasonable insurer’s behavior).

Illustration

13. Prospective Reinsured A, a general liability insurer, is aware that a customer has brought suit against a policyholder alleging manufacture of a dangerous product that injured the claimant. A is aware that the policyholder has manufactured and distributed tens of thousands of these products during the first year of its product’s availability. A does not disclose this information when entering into a contract of reinsurance with Reinsurer B. Six months later, scores of lawsuits are filed against the manufacturer policyholder, alleging injury from the policyholder’s product. A defends these claims and pays settlements or judgments in connection with most of them. A then seeks reimbursement from B. B refuses, contending that A breached its duty of disclosure in view of the materiality of the omitted information about the defective product. If B can show that it would not have entered into the contract and that a reasonable and prudent reinsurer would not have entered into the reinsurance contract in question without charging a higher premium, B is entitled to the remedies provided by Article 3.2. This is an inherently fact-specific and fact-intensive inquiry that hinges on the particular circumstances. For example, if the claimant customer alleges that the product of Reinsured A’s policyholder was defectively designed and that the defect affects all of the thousands of products sold, this obviously strengthens B’s case for rescission. But it is still only one lawsuit. If a claims professional would regard the suit as clearly unfounded, it may not be material even if it is alleged to be a systemic defect in the product. If the customer’s lawsuit alleges defective manufacture of the product, the materiality of the representation may turn on whether it is an allegation of a single oversight by an overworked assembler or whether it is alleged that the entire manufacturing process was flawed.
14. Prospective Reinsured A, an insurer of commercial marine vessels, contracts with Reinsurer B for reinsurance. A fails to disclose instances where two insured vessels were damaged while using a particular port and that the cause of damage was a defect in the port’s docking system. After inception of the reinsurance contract, a third vessel is injured in a similar way and A pays the claim. A then seeks payment from B. B investigates and discovers the earlier

injuries. B will prevail on its contention that A breached its duty of disclosure. The facts and circumstances of the prior injuries to the two other vessels is material to the risk assumed by B. Had B known, it would have only entered into the reinsurance contract on different terms or in return for a higher premium. See, e.g., *A/S Ivarans Rederei v Puerto Rico Ports Authority*, 617 F2d 903 (1st Cir 1980)(applying maritime law)(the insured's failure to disclose two prior incidents of damage to vessels due to defect in dock precludes insurance coverage for injury to third vessel).

- I5. Reinsured A, a marine insurer, obtains reinsurance from Reinsurer B but has failed to inform the reinsurer that an insured vessel has already sailed and suffered injury at sea. The reinsurance contract becomes effective while the vessel is at sea. The ship returns to port and makes a claim that is paid by A. A then seeks reinsurance from B. A's failure to inform B about the ship's pre-existing damage is a breach of A's duty to disclose and entitles B to the remedies provided by Article 3.2. See, e.g. *Merchants' & Shippers' Ins Co v St. Paul Fire & Marine Ins Co*, 219 AD 636, 220 NYS 514 (1st Dept 1927), *aff'd*, 246 NY 616, 159 NE 674 (1927) (the insured's failure to declare that the vessel carrying insured cargo had already sailed and suffered injury causing delay *en route* was a material omission barring coverage). In addition to the defense of non-disclosure, B may also have a defense to payment because the losses in question flow from injury that predates the effective date of the reinsurance contract.
- I6. Reinsured A, a property insurer, enters into a reinsurance contract with Reinsurer B covering A's exposure to loss of a shipment of 500 "clocks" from Spain to Chile. The cargo is lost at sea, when it is then discovered that the cargo was expensive Rolex watches. A's failure to disclose is in part because the same Spanish word ("*reloj*") describes both clocks and watches and depends on context to clarify meaning. A thus claims that its failure to inform B of the expensive nature of the cargo was an innocent linguistic mistake. A is incorrect. Even if material non-disclosure is not intentional or fraudulent, it remains material non-disclosure that violates the duty of utmost good faith. Even if the cargo has been accurately identified as "watches," "wrist watches," or even "expensive wrist watches" A's non-disclosure is material to the risk assumed by B under the contract. Because Rolex watches cost quite a bit more than even watches generally described as expensive, an objectively reasonable and prudent reinsurer would have insisted on a higher premium or refused to contract, had it known the value of the cargo was USD 4 million rather than the USD 25,000 to USD 250,000 at which one would value a cargo of wrist watches ranging between cheap (USD 50 or less) and expensive (up to USD 500) in individual prices. See, e.g., *Wise Underwriting Agency v Grupo Nacional Provincial SA* [2003] EWHC 3038, [2004] 14 Mealey's Reins Rep No 23, A, *rev'd on other grounds* [2004] EWCA Civ 962, [2004] 15 Mealey's Reins Rep No 7 a (the reinsured's description of the cargo of Rolex watches as "clocks" due to mistranslation from Spanish is a material misstatement that, even if innocent, precludes coverage).

17. Reinsurer B is considering renewal of a contract with Reinsured A, a US liability insurer. During the term of the contract, the US Supreme Court issues a decision overruling a precedent that had made it more difficult for foreigners to sue in the United States for injuries suffered abroad. See, e.g., *Piper Aircraft v Reyno*, 454 US 235 (1981) (the US court would abuse its discretion in refusing to dismiss a lawsuit involving an airplane crash in Scotland on ground of inconvenient forum where victims were not Americans and important evidence was located in Scotland, despite fact that defendant manufacturers were US companies). The effect of the new decision is to make it somewhat more likely that US-based plaintiffs' counsel will be able to file suit in the US, which has a more plaintiff-friendly legal regime, rather than in their home countries or the country in which injury took place. A need not disclose this development to B. First, it is public information that is readily available to B as well as A. Second – and more importantly – only a small portion of US civil claims involve this kind of aggressive international forum shopping by counsel, which makes it unlikely that the decision will cause any significant increase in claims payments by A. Failing to inform B of the court decision is not a breach of the duty of disclosure by A. A reasonably prudent reinsurer would not be deterred from accepting the risk or would not charge a higher premium solely because of this change in US law.
18. Same facts as the previous Illustration in that Reinsurer B is considering renewal of a contract with Reinsured A but A is a liability insurer whose sole market is insurance of state and local governments against tort liability. During the term of the contract, five US States with small populations have increased their cap on tort damages against the state from USD 50,000 to USD 100,000. In addition to being information in the public domain, this information is almost certainly not something that would prompt a reasonable, prudent reinsurer to refuse renewal. It is also highly unlikely to be the type of information that would prompt B to insist on an increase in premiums.
19. Same facts as the previous Illustration in that Reinsurer B is considering renewal of a contract with Reinsured A, a government liability insurer, but during the term of the contract, 30 US States have doubled the size of their caps on tort damages against the state, raising the average cap on damages from USD 150,000 to USD 300,000. There are tens of thousands of such suits brought against state and local governments each year, with approximately ten percent of them reaching the USD 150,000 cap due to payment of settlements or judgments. This is a closer case whose resolution may depend on additional facts and context. But the most likely result is a finding that A breached its duty of disclosure by not informing B of these developments during renewal negotiations. Although the information is publicly available, A is a specialist in government risk exposure, has the information, and could easily inform B. Because of the magnitude of the change and the large number of affected lawsuits, B as a reasonably prudent reinsurer would almost certainly insist on an increased premium to accommodate this increased risk.

5. What constitutes materiality

- C5. In its form prior to the Amendment by the *UK Insurance Act 2015* (effective as of 12 August 2016), section 18(2) of the *UK Marine Insurance Act 1906* provided that a matter is material if it “would influence the judgment of a prudent insurer in fixing the premium or determining whether he will take the risk.” This approach to materiality is consistent with statutes and case law in the majority of jurisdictions regarding not only marine insurance and reinsurance but for contracts generally. See PERRILLO § 9.14; FARNSWORTH §§ 8.15, 8.16. See, e.g., *Penn Mut Life Ins Co v Mechanics’ Savings Bank & Trust Co*, 72 F 413, 430 (6th Cir 1896)(applying Ohio law) with opinion by future US President and Supreme Court Justice William Howard Taft (framing the materiality inquiry as whether a reasonably prudent insurer would have “enhanced the premium to be charged” or whether there would have been a “rejection of the risk”). But see *Wigmore on Evidence* § 1946, where the noted early Twentieth Century US evidence scholar endorsed a subjective approach based on the specific insurer’s reaction rather than that of reasonable insurer); § 334 *California Insurance Code* (materiality is determined by “the probable and reasonable influence of the facts upon the party to whom the communication is due, in forming his estimate of the disadvantages of the proposed contract, or in making his inquiries,” a subjective standard). *Accord*, *Napier v Allstate Ins Co*, 961 F2d 168, 170 (11th Cir 1992)(applying Georgia law).

6. An objective standard for determining materiality – but one that requires the reinsurer subjectively adhere to the standard

- C6. This Section of the PRICL a standard of materiality that incorporates both subjective and objective definitions of materiality. An omission is material if it would have affected the decision of a reasonable reinsurer regarding making the agreement, including the pricing and terms of the reinsurance in question. See, e.g., *Pan Atlantic Ins Co Ltd v Pinetop Insurance Co* [1994] 2 Lloyd’s Rep 427 (House of Lords); *Brotherton v Aseguradora Colseguros SA (No 2)* [2003] 2 All ER (Comm) 298 (Court of Appeal). See also *Assicurazioni Generali SpA v Arab Insurance Group (BSC)* [2002] EWCA Civ 1642 (misrepresentation or non-disclosure must be the effective, but need not be the sole cause of entering into agreement; but if the reinsurer would have made an agreement on the same terms even if accurately informed by reinsured, the information is not sufficiently material to justify rescission or denial of coverage).
- C7. To be material for purposes of avoiding a reinsurance contract, the undisclosed information must not only be of the type that would affect an objectively reasonable insurer but the actual reinsurer must itself have regarded the information as sufficiently material to decline the risk or charge a higher premium had it known the undisclosed information. See, e.g., *Pan Atlantic Ins Co Ltd v Pinetop Insurance Co* [1994] 2 Lloyd’s Rep 427 (House of Lords); *Brotherton v Aseguradora Colseguros SA (No 2)* [2003] 2 All ER (Comm) 298 (Court of Appeal). The PRICL’s concept of materiality is thus consistent with that applied in English courts.

7. The advantages of an objective component in the standard for determining materiality

- C8. An approach to materiality that contains an objective component is superior to a purely subjective approach in that it provides better and fairer notice to insurers seeking to purchase reinsurance. Applicants must consider whether a reasonably prudent insurer would want to be informed of certain facts known to the applicant. Prospective reinsureds are, of course, insurers that are in the business of risk management. They can fairly be charged with knowing what information would impact the decisions of a reasonable reinsurer. But it is unfair to ask prospective reinsureds to read the subjective mind of the reinsurer and calculate what information it might consider material beyond that which would be material to an ordinary reasonable reinsurer. Adopting an approach that examines not only the subjective behavior of the reinsurer in question but also the objective views of reasonable reinsurers as a whole provides clearer guidance to the parties considering entering into a reinsurance agreement and prevents a reinsured from losing cover based on the idiosyncratic views of a single reinsurer. It should be noted that a finding of a material omission does not automatically equate to a finding that the material non-disclosure caused injury.
- C9. Objective consideration – either alone or coupled with a subjective component – also improves resolution of reinsurance disputes. One could make a compelling case for using only an objective standard. Under a purely subjective approach, the particular mindset of a particular insurer is a question of fact that logically requires fact finding through trial, which in the United States means impaneling a jury of laypersons unfamiliar with the insurance/reinsurance business who are governed by restrictive rules of evidence. This makes for a cumbersome, time-consuming, and costly process that may easily result in error if jurors are swayed by false testimony (e.g. the insurer that asserts that it would not have entered into the contract if it had known that the reinsured's claims personnel wore uniforms while on the job) or wrongly disbelieve reasonable testimony (e.g. the reinsurer that asserts it would not have made the agreement if it had known that the reinsured issued its large life insurance policies without requiring a physical examination).
- C10. Another advantage of a purely objective standard is that a tribunal will often be able to apply the objective standard of materiality as a matter of law because in many cases, there will be no dispute regarding whether a reasonable and prudent reinsurer would find an omitted fact sufficiently important to affect underwriting decisions. Nonetheless, because the importance of the subjective view of materiality of the reinsurer actually involved in the contract has legal support, particularly in English law, the PRICL adopts a standard of materiality that contains both objective and subjective components.

Illustrations

- I10. The contract between Reinsured A and Reinsurer B is up for renewal. During the contract term, the top managers of A have been convicted of wire fraud. Because an objectively reasonable reinsurer would consider this information in determining whether to continue to do business with A, the information is material and should be disclosed. This is the case even if there is some evidence that B has historically been less concerned with the criminal justice

difficulties of insurance executives than is the typical reinsurer. However, if there is sufficient evidence that B is not at all concerned with the criminal records of a reinsured's personnel, the criminal convictions of A's managers are not material and do not provide a basis for permitting B to rescind the contract.

- I11. A, a Directors' & Officers' (D&O) insurer, is seeking to enter into a reinsurance contract with B and fails to disclose that a majority of the directors on the board of A are not "independent" as the term is generally understood in the relevant industry. The clear norm among reinsurers is to refuse to cover companies that lack a majority of independent directors on the board, but B has no prohibition on this and there is evidence that B does not consider this important in assessing risk. A's non-disclosure is not material and does not provide a basis for avoiding the contract.

8. Proof regarding an objectively reasonable reinsurer

- C11. It should be recognized that the market for certain insurance products may be relatively small, making it more difficult to ascertain the behavior of the hypothetical reasonable insurer in such thin markets. Nonetheless, even in these circumstances, there remains an objective component in the standard for assessing materiality. But as a practical matter, the evidentiary submissions and testimony of the actual insurer involved – and the particular insurer's rationale for regarding non-disclosure as material – will logically take on greater importance than it would in disputes involving common forms of insurance, for which there exists ample information regarding industry norms.

9. Proof regarding the subjective views of a particular reinsurer

- C12. The materiality of a particular non-disclosure or misstatement to the reinsurer on the risk is a question of fact subject to proof like any fact in the tribunal adjudicating the dispute. The reinsurer may establish its subjective assessment of materiality through documents (e.g. underwriting guidelines, internal memoranda or emails), testimony, past practices or other admissible evidence and must do so by a preponderance of evidence if it is to avoid a contract on grounds of material misrepresentation or non-disclosure.

10. The impact of a treaty on the materiality question and required disclosure

- C13. A distinction can be made between not only facultative certificates and reinsurance treaties but between types of treaties and the degree to which the treaty gives the reinsurer no discretion regarding acceptance of risk. Treaties can be subdivided into what might be terms "contracts *of* reinsurance" and "contracts *for* reinsurance." The former are treaties in which the reinsurer is obligated to accept all risks tendered by the reinsured and may not refuse. The latter are treaties that provide the reinsurer with at least some authority and discretion to reject tendered risks. Although reinsurers in the latter situation of treaties for reinsurance are less vulnerable than reinsurers that have entered treaties of reinsurance, the same duty of utmost good faith applies to both situations and requires similar candor and disclosure obligations of the reinsured.

11. Elements of required disclosure

C14. The reinsured's duty of disclosure ordinarily requires that the reinsured: (a) provide accurate loss information that presents a fair picture of the risk to be assumed by the reinsurer; (b) update all information in the event of significant change during the negotiations; (c) respond frankly to reinsurer inquiries; (d) raise potential issues affecting the risk that are material even if not raised by the reinsurer; (e) outline the structure of the reinsurance program and cover sought; (f) identify any other applicable reinsurance that may cover the risks in question. Additional examples of information material to reinsurance underwriting include claims experience, loss information, information regarding significant risk exposures, and financial information concerning the capital and surplus of reinsured and reinsurer, including any significant regulatory matters affecting them.

Illustrations

- I12. Prospective Reinsured A is negotiating with prospective Reinsurer B to form a contract. A informs B of several lawsuits alleging harm from the over-the-counter, non-prescription drugs made by a large policyholder. A fails to inform B that the policyholder has been told by a regulatory agency that the policyholder's drug will soon be labeled "unsafe" and that the policyholder will be required to cease selling the drug and pull it from the shelves. The contract is formed. A month later, the regulatory agency action is announced. A spate of lawsuits against the policyholder follows, forcing A to defend and pay many claims for which it seeks payment from B. B can resist payment based on A's breach in its failure to disclose. The information regarding regulatory action is not public and would affect a reasonable reinsurer's decision as to whether to accept the risk or charge a higher premium and would presumably be the attitude of B as well. The full extent of B's remedies is subject to Article 3.2.
- I13. Same facts as the previous Illustration, except that when negotiations begin there is no indication that regulatory authorities are considering banning sale of the drug. A becomes aware of this during the contract negotiation process. A should disclose this information to B.
- I14. Same facts as the previous Illustration. Before A discovers the planned regulatory action, B asks whether A is aware of any regulatory problems facing any of A's policyholders. A truthfully answers in the negative. The next day, A learns of the planned regulatory action. A must update and amend its answer to B's question.
- I15. B does not ask about environmental risks in A's portfolio. Although primarily a seller of general liability policies that include a pollution exclusion, A also sells a significant number of environmental impairment policies. Even though not specifically asked about this by B, A must disclose this aspect of its business to B.

- I16. Same facts as the previous Illustration, except that A has only small number of environmental impairment policies due to having acquired a smaller insurer. Unless A is aware of particular claims that are significant in number or amount that are highly likely to be made pursuant to these policies, A is not obligated to disclose this information to B.
- I17. A is seeking facultative reinsurance from B for a particular book of risks. Although not certain, losses from this book of A's business may also be covered under treaty reinsurance that A has in place for much of its business. A is required to disclose this to B.
- I18. Same facts as the previous Illustration, except that it is clear that A's treaty reinsurance is inapplicable to the facultative risk that it is seeking to place. A need not disclose information about its treaty reinsurance to B unless asked by B as part of the contracting process.

12. Inquiries propounded by the reinsurer are presumptively material

- C15. The obligations imposed by the duty of utmost good faith set forth minimum obligations regarding disclosure. Additional disclosure obligations can be created by specific questions propounded by the reinsurer as part of the contracting process. Where a reinsurer propounds a question to the reinsured, this creates a rebuttable presumption that the information sought is material to the risk. However, to obtain the benefit of this presumption, a reinsurer's question must be reasonable and may not be overbroad or unduly vague. The reinsured may rebut the presumption of materiality if the facts of the situation demonstrate that the inquiry did not seek material information.
- C16. Although inquiries made by the reinsurer are presumptively material, the reinsured may rebut the presumption based on the facts of a situation. For example, if a reinsurer during the underwriting process propounds a question seeking information that no reasonable reinsurer would regard as material, an absent or incorrect answer to such a question may not affect coverage if the reinsured can demonstrate the lack of materiality and if the deficiencies of the response to the question did not involve fraud or deceit. The reinsured bears the burden of proof to demonstrate lack of materiality of a reinsurer's inquiry.
- C17. The parties may also agree to provide additional disclosure not required by the duty of utmost good faith and the materiality standard

Illustrations

- I19. Ordinarily, a question about the leisure time habits of employees of the insurer would not be sufficiently relevant to the risk presented by the insurer's policyholders to carry a presumption of materiality. Prospective Reinsurer B asks prospective Reinsured A whether any of its executives engage in recreational sky diving. Even though A thinks the question is odd (or even ridiculous), A must answer the question truthfully. Failure to do so is a misrepresentation. However, whether the misrepresentation is sufficiently material to impact coverage is determined by whether an objectively

reasonable reinsurer would consider the question material and also requires that B adhere to this view. In this Illustration, B's inquiry may seem odd but it probably should be treated as material as the risk of the untimely death of members of A's top management may affect a reasonable reinsurer's willingness to accept the risk and the premiums charged. However, if the facts show that the skydiving propensities of A's managerial team do not significantly increase management mortality or the risk of management turnover from job changes, retirement, or relocation, an incorrect response to the question by A would not be a material misrepresentation.

- I20. Same facts as above but instead of asking about skydiving, B asks whether A has a wellness program in place for its top managers. A erroneously answers in the affirmative. This is a misrepresentation and B is entitled to the presumption of materiality for the reasons discussed in the previous Illustration. But because the existence of a wellness program is rather attenuated from the continuity of management, A is allowed to attempt to rebut the presumption. If it does so successfully, the incorrect answer to the wellness program question is not a basis for rescinding reinsurance cover.
- I21. Same facts as above but B asks about whether there is a wellness program for all employees. A erroneously answers in the negative. B has the benefit of the rebuttable presumption but A is more likely to successfully rebut than in the previous Illustration because efforts to promote the health of company employees generally is less likely to be deemed material than efforts to promote the health of top management. But if B can show that such programs are associated with a workforce that makes sounder underwriting and claims decisions and that this would affect a reasonable reinsurer's decision to contract, B may continue to enjoy the benefit of the presumption of materiality.
- I22. Late in the underwriting process, prospective Reinsurer B asks prospective Reinsured A: "Is there anything else we should know?" The question is too vague to carry a presumption of materiality or to make every non-disclosure material.
- I23. A and B have stipulated that "in seeking reinsurance, A will truthfully answer all inquiries propounded by B, whether or not material and that any inaccurate answer by A will make the contract voidable at the discretion of B." B asks whether A's top managers play handball. A erroneously answers in the negative. A's misstatement in its answer is a breach of its duties. Whether B could avail itself of the extreme remedy of avoiding the contract entirely would be determined by the remedies provisions of Article 3.2 and applicable contract law concerning disproportionate forfeiture.
- 13. In addition to the requirement of providing material information, the duty of utmost good faith requires the parties to respond with candor and cooperation to reasonable inquiries**
- C18. The duty of utmost good faith requires the parties to respond to reasonable requests for information. Where either party to a reinsurance contract propounds clear and precise

questions to the other in respect of information material to the inquiring party, the party receiving the inquiry has a duty to answer fully and truthfully based on the circumstances of which the party is aware or should be aware if exercising reasonable care in its response. This duty is limited to reasonable requests. In response to an irrelevant request or one that is unreasonably broad or burdensome, the reinsured may limit its response to one that is reasonable under the circumstances and in extreme cases can reject a completely unreasonable request.

Illustrations

- I24. Reinsurer B asks Reinsured A to furnish copies of all policies and endorsements subject to the reinsurance. This request is overbroad and unduly burdensome. A may refuse but should request that B explain the purpose for which it is seeking the information and attempt to come to an accord with B by providing information that will respond to B's reasonable concerns without imposing an undue burden upon A.
- I25. B asks for detailed numbers from A, an automobile liability insurer, regarding the percentage of its policies sold to residents of a particular jurisdiction known for large awards to bodily injury plaintiffs and the total policy limits in force in those jurisdictions. If asked in a sufficiently clear fashion by B, A should provide the information unless A can demonstrate that it is unduly burdensome or that A can provide information responsive to B's concern in a more efficient manner.
- I26. B asks A "What percentage of your general liability policyholders are residents of Texas?" Although the question is broad, A should provide as much information as it reasonably can (e.g. "We have 10,000 GL [general liability] policies in Texas" or (better) "Twenty percent of our GL policyholders list Texas as the company headquarters" or similar responses that can efficiently be derived from A's aggregate data).
- C19. Depending on the specificity of the question and the amount of information available, answers of a more general nature may be appropriate. For example, if a reinsurer asks whether a reinsured has a "good" loss ratio, such a question permits of a general answer. But a request for detailed information should ordinarily result in the provision of detailed information. Consequently, if the reinsurer asks the reinsured for its precise loss ratio, the reinsured must answer accurately and truthfully.
- C20. A prospective reinsured may refuse to answer a question on the ground that it does not have the information readily available and does not want to invest resources in obtaining the information. A candid response of this type does not violate the duty of utmost good faith – although it of course may make the reinsurer unwilling to enter into an agreement with the prospective reinsured.
- C21. In addition, the prospective reinsured may impose duties of disclosure upon the prospective reinsurer through sufficiently specific inquiry even though the prospective reinsured does not propound an application to the prospective reinsurer.

Illustrations

I27. Prospective Reinsured A asks questions about the financial stability of prospective Reinsurer B. Although B is not required to answer any of these questions and may decline on proprietary grounds (just as it may decline to enter into an agreement with a prospective contracting party), B is obligated to provide sufficiently complete and truthful answers if it responds to the questions.

I28. A asks about the reinsurer's investment in equity stocks. If B, which has twenty-five percent (25%) of its investment portfolio in equities responds that the amount of its investment in equities is "very low," this may constitute a misrepresentation if this degree of concentration in equity stocks creates more than an incidental risk exposure for the reinsurer.

14. The disclosure obligations of the duty of utmost good faith apply regardless of the size, wealth, or sophistication of the contracting parties

C22. Reinsureds are held to the standards of accountability set forth in the PRICL regardless of their size, wealth or sophistication. This flows from the principle that all entities are subject to controlling legal rules and the principle that entities involved in a particular trade or business should observe the norms of that trade or business.

15. Where information provided is incomplete or confusing, the reinsurer has a duty of reasonable inquiry to attempt to rectify the disclosure

C23. Reinsurers have a duty to conduct further examination of the information provided by a reinsured in cases where that information would be viewed as obviously incomplete or unclear to a reasonable reinsurer. Submissions by a reinsured that raise questions create a duty of inquiry on the part of the reinsurer.

Illustration

I29. During renewal negotiations, Reinsured A, an automobile liability insurer, states that it has 20,000 policies in force in California. When originally seeking reinsurance from Reinsurer B a year before, A stated that it had 200,000 policies in force. B has a duty to clarify the discrepancy and to determine whether A really had a ninety percent (90%) drop in business in just a year. On these facts, B cannot accept the representation and then attempt to use it as grounds for contract avoidance or other remedy when the face of the disclosure so clearly suggests a typographical error or similar mistake.

16. Duties upon renewal or commutation

C24. If a reinsurance agreement is subject to renewal, the duties set forth in this Section regarding initial contracting continue to apply during the renewal process. These duties also apply if the reinsured and the reinsurer enter into discussions regarding commutation of the agreement.

- C25. The process of renewal of an insurance policy or reinsurance agreement is generally more informal and streamlined than the initial process of entering into the agreement. However, the same duties of utmost good faith apply. A reinsured cannot fail to disclose material information in order to obtain a renewal that would not have taken place if the information had been disclosed. A reinsurer cannot accept a renewal premium knowing that it is days away from becoming insolvent. These sorts of behaviors violate the duty of good faith.
- C26. Similarly, when a reinsured and a reinsurer decide to commute the reinsurance agreement, both must satisfy the good faith standard in their disclosures and other dealings with one another. It violates this Article, for example, if a reinsured incorrectly claims that there is a pipeline of serious claims that have not yet been reported. This in turn induces the reinsurer to make a commutation it would otherwise have resisted or induces commutation on terms more favorable to the reinsured.

17. Determining what a reinsured “knows”

- C27. In assessing what a reinsured “knows,” the reinsured is viewed as an entity. The entity must have actual knowledge of the information in question – but the entity is deemed to have actual knowledge of what its employees and agents actually know. For example, if claims personnel or legal personnel of the reinsured know that recent court decisions have removed certain defenses to liability or that a product previously deemed safe has been held to be defective and dangerous, that knowledge is imputed to the reinsured entity for purposes of this Article of the PRICL. However, imputed information is not necessarily material. Materiality of the information is assessed according to the criteria set forth in this Article. In similar fashion, the reinsured as an entity is responsible for errors in reporting material information, even if the errors were not made fraudulently or recklessly. A reinsured is held accountable for what it tells the reinsurer, even if the error is unintentional.

Illustration

- I30. Due to a typographical error, prospective Reinsured A reports that it has issued 2,000 automobile liability policies in California when the correct figure is 200,000). This would be a material misrepresentation as well as a breach of the duty of utmost good faith. Because there are approximately 29 million registered automobiles in California, if the actual number was 20,000, this typographical error would likely not be material. A’s misrepresentation breaches its duty of utmost good faith in disclosure regardless of whether accidental or intentional, although intentional misrepresentation may expand the remedies available to B pursuant to Article 3.2.

18. The burden of proof regarding non-disclosure

- C28. Unless there has been an inquiry during the application, underwriting, or renewal process, a reinsurer that asserts that the reinsured failed to disclose information material to the risk reinsured bears the burden of persuasion to demonstrate not only that the information was not provided but also that the undisclosed information was material. As

provided in this Article, non-disclosure or misstatement in response to a particular inquiry is presumptively regarded as material.

19. Burden of proof to show materiality

C29. Absent inquiry, it is the reinsurer's burden to prove the materiality of a non-disclosed or misrepresented fact. As summarized by one leading treatise:

The effect of the decision is that a reinsurer can avoid the contract for non-disclosure and/or misrepresentation of material facts if it can prove:

(a) that the mind of prudent underwriter would have been influenced although it need not be shown that it would be decisively influenced [and that] a prudent underwriter would have taken the matter into account but would not necessarily have acted any differently (for the purposes of establishing the attitude of a prudent underwriter reference is usually made to the evidence of an independent expert underwriter); and

(b) that the non-disclosure induced the *actual* underwriter to write the reinsurance on the terms which he did. In the event that the actual underwriter is not available to (or cannot give evidence), there is a presumption of inducement, i.e., it is presumed that in the event of a material non-disclosure, the reinsurer relied on it. It is up to the reinsured to prove that the reinsurer did not. This is a difficult presumption to rebut.

CLYDE & CO 1.77 (italics in original). English law thus can be construed as defining materiality according to both an objective standard (would a prudent/reasonable reinsurer have made this particular agreement if the true facts were known) and a subjective standard (would this particular reinsurer have made this particular policy if the true facts were known), enhancing the subjective prong of inquiry by creating a presumption of reliance based on the objective standard if the particular underwriter is not available to provide evidence. See also CLYDE & CO 10.25-10.48. As previously noted, the objective standard is the majority rule in the United States but there are several states (most prominently California) that apply a subjective approach. See STARING AND HANSELL § 10:3.

SECTION 3: DUTIES OWED DURING THE CONTRACT PERIOD

ARTICLE 2.3.1

(Premium payment)

(1) Premiums shall be paid by the reinsured in accordance with the terms of the contract. The reinsurer is required to demand payment in order to trigger the reinsured's payment obligation. Premiums shall be paid promptly after demand has been made.

(2) Where premium payment is late, i.e., after expiration of the period provided by paragraph (1), the reinsurer is entitled to interest in accordance with Article 7.4.9 PICC.

COMMENTS

1. The duty of utmost good faith requires reasonably prompt payment in spite of countervailing economic interests of the reinsured

- C1. Insurers and reinsurers traditionally make much of their revenue from investment income on the “float” – premium dollars received that are not paid out in claims until a future date. During this period, the insurer or reinsurer earns investment income. As a result of this basic fact of the insurance business, both insurers and reinsurers have an imbedded incentive to delay payment of claims. Reinsureds also have an incentive to delay paying premiums to the reinsurer (which must largely come from the premiums collected from policyholders by the reinsured). Good faith performance of the reinsurance agreement requires that the reinsured make premium payments to the reinsurer in timely fashion as provided by the agreement or, if no specific time is set in the agreement, within a reasonable time after payment has been demanded by the reinsurer. As established by other provisions of the PRICL, the duty is reciprocal in that just as the reinsured cannot unreasonably delay paying premiums, the reinsurer cannot unreasonably delay paying claims. See Article 2.4.5 (requiring timely payment of claim upon proper presentation of claim).

2. Interest on late payments

- C2. Where payment of premium is late, the reinsurer is entitled to a reasonable and fair rate of interest applied from the time the late premium was due until the time of payment. Article 7.4.9(2) PICC, which is adopted by reference in paragraph (2), provides for interest at the “average bank short-term lending rate to prime borrowers prevailing for the currency of payment at the place for payment, or where no such rate exists at that place, then the same rate in the State of the currency of payment.” If neither of these measures of interest is available, the interest rate is “the appropriate rate fixed by the law of the State of the currency of payment.”

3. The parties may modify the general premium payment standards of the Article

- C3. In practice, the reinsurance contract will typically provide specific guidance regarding when premiums are due (a premium payment clause), as well as a provision specifying when premium payment is considered overdue, the specific interest rate to be applied to overdue payment and a claims settlement clause that specifies when payment in connection with claims settlement is due. Where such terms are provided, they shall be enforced if commercially reasonable. Article 2.3.1 provides only a default rule in the event the reinsurance contract is silent or its meaning cannot be discerned. It is not an immutable rule.

4. In appropriate circumstances, payment may be made through set-off rather than actual cash payments

- C4. Reinsurance premium payment is more complex than premium payment in the insurance context, which generally involves the policyholder simply writing a check to the insurer (although there can also be retroactive premium rating and adjustment). By contrast, many reinsurance transactions involve set-off of entitlements and liabilities

concerning a given reinsurance contract or a number of transactions involving the reinsurer and the reinsured.

- C5. Payment by set-off is common and is consistent with this Article of the PRICL. Similarly, particularized agreement regarding set-off protocol is common. Furthermore, either by agreement or custom in some markets (e.g. London), set-off is often administered by the reinsured's broker and the reinsurer rather than by the reinsured itself.
- C6. Unless otherwise agreed by the parties, set-off in reinsurance contracts shall be governed by the rules set forth in Chapter 8 PICC (setting forth criteria and protocol for set-off and providing illustrative commentary).

ARTICLE 2.3.2

(Contract documentation)

The parties shall cooperate regarding documentation of any agreement and shall seek reasonably prompt documentation of the contract.

COMMENTS

1. The importance of timely contract documentation and the scope of the obligation

- C1. Traditionally, both insurance and reinsurance have involved significant separation between the time at which a risk is placed and the time at which a finalized documentation of the agreement is provided. This separation may create problems in that significant claim activity can occur during this period, creating potential for coverage disputes because there is not a textual memorialization of the agreement. To minimize such disputes, reinsurers should provide a finalized documentation of the agreement as soon as feasible after the agreement is reached. The documentation should of course fairly and accurately represent the substance of the agreement. An attempt by either party to "sneak in" a provision inconsistent with the scope and understanding of the parties at the time the agreement is made would not be consistent with the duty of utmost good faith. The duty to make fair, accurate, and prompt documentation applies not only to reinsurance treaties and facultative certificates but also to other agreements made by reinsureds and reinsurers in the course of performing their respective duties and exercising their respective rights related to the reinsurance contract.

2. The basic requirements of documentation

- C2. Documentation alone, of course, does not remove the possibility of disputes. The resulting agreement should be sufficiently comprehensively documented that the text sets forth the major terms and provisions of the agreement. The goal is to provide "contract certainty" by having the written agreement adequately address the terms of the agreement in sufficiently clear fashion. Such documentation is not a panacea for avoiding disputes. The parties may disagree over the meaning of the text of the

documentation. Or they may argue that extrinsic information, context, or custom and practice provide a basis for decisions outside or even in derogation of the text. But prompt and thorough documentation of a reinsurance agreement will reduce the instances and costs of disagreement over the meaning of the agreement. The concept of good order includes reasonably timely and current record-keeping as well as sufficiently complete and comprehensive record-keeping.

3. Contract certainty

- C3. Regarding contract certainty, the London Market has, since 2007, utilized a *Contract Certainty Code of Practice*, which was created by its Market Reform Group, and is now maintained by its London Market Group. Although the *Contract Certainty Code of Practice* is aimed primarily at insurance, it logically sets forth an industry standard as to reinsurance placement and documentation as well.
- C4. The concept and goal of contract certainty is that each party will know exactly what the product is that is being sold at the time it is being sold, so it can be priced correctly and so the purchaser knows exactly what it is buying without any later misunderstandings. The objective of contract certainty is to provide clarity for both reinsured and reinsurer on the terms and conditions of the contract by the time that they enter into the contract.
- C5. As stated in the Code: “Contract Certainty is achieved by the complete and final agreement of all terms between the insured and insurer by the time that they enter into the contract, with contract documentation provided promptly thereafter.” It is not regarded as sufficient to use words such as “terms to be agreed” when forming a reinsurance contract. Rather, all terms to be memorialized in writing should be agreed upon by the inception date of the reinsurance contract. Although the *Contract Certainty Code of Practice* does not have force of law, it represents industry understanding and best practices for UK-regulated general insurers and is followed in principle by most participants in the London Market.⁴ Contract certainty has now been introduced on a very similar basis in Bermuda, New York, and Singapore.
- C6. The *Contract Certainty Code of Practice* (reprinted in Appendix of the PRICL) sets forth eight principles (e.g. Principle No 2: “Each insurer will be satisfied that the submission [of a broker on behalf of a prospective insured or reinsured] meets the contract certainty definition and checklist before formally committing to the contract, ensuring that any conditions or objectives are clearly expressed” with [Principle No 3]

⁴ Before the concept of contract certainty was introduced, a brief summary of the main terms of the reinsurance was agreed upon and represented only be a brief writing (the “placing slip”, or simply a “slip”). Much later, often more than a year, the full reinsurance contract wording was issued to replace it. If there was a major loss in the meantime, this often led to disputes regarding terms that were unclear or unknown. Placing slips did not always accurately reflect the material terms of the reinsurance agreement. Primary concerns underlying the adoption of the *Contract Certainty Code of Practice* were: (1) Incomplete contracts – often the slip did not accurately reflect the material terms of the reinsurance agreement (the terms set out on the slip were unclear, including such problems as: unclear referencing to specific clauses which were meant to apply, missing payment terms, unclear parties to the contract, unclear reinsurance cover, unclear subject matter of the reinsurance); (2) Delayed receipt of signed contract wording; and (3) Risk of two competing contracts in existence – the slip as the provisional contract until it had been superseded by the signed contract wording as the finally agreed contract. In this sense, until a full reinsurance contract wording was signed by both parties, the slip was the record of the reinsurance contract between the parties. Although, legally the signed wording generally took precedence over the slip, when the terms of the slip and contract wording were fundamentally different, there were sometimes legal disputes as to whether the slip or contract wording took precedence.

brokers to “notify all terms to their client and obtain their client’s agreement before inception” of the contract) that should be met, including that insurers provide “appropriate evidence of coverage” within 30 days of the inception date of a contract. Although the PRICL do not set forth a specific time limit for providing the “reasonably prompt memorialization of the reinsurance contract” required by Article 2.3.2, the 30-day period of the Code provides a useful benchmark.

- C7. In addition to defining contract certainty as “the complete and final agreement of all terms (including signed lines) between insurer and insurers before inception” of the contract, the “full wording” of the contract “must be agreed before any insurer formally commits to the contract” and there must be the “appropriate evidence of cover” noted in Comment 5 above. “Full wording” of a submission seeking insurance is to be “a combination of: (i) wordings and/or clauses; (ii) either referenced and/or full text; and (iii) bespoke [customized]⁵ and/or model material” with brokers allowed to “choose which combination is submitted to insurers” who in turn “may choose whether to accept this or require a different approach” to documenting the contract.
- C8. Where a party to a reinsurance contract has not met the requirements of this Article, the tribunal deciding a dispute arising out of the contract may take this into account in rendering its ruling. In determining the relative responsibilities of the contracting parties regarding documentation and the consequences of inadequate documentation for the purpose of contract construction, Articles 2.1.12 and 2.1.17 PICC provide useful guidance. See Article 2.1.12 (where writing in confirmation is sent within a reasonable time after formation of the contract, additional or different terms stated in the purported confirmation become part of the agreement unless they materially alter it or the recipient makes timely objection); Article 2.1.17 (where a written contract states that it contains the entire agreement between the parties, the contract cannot be contradicted or varied by evidence of prior statements or agreements but such information may be used to interpret the writing).

⁵ The term “bespoke” is more prevalent in the UK while “customized” or custom-made is the more common term in the US.

ARTICLE 2.3.3

(Notice of changed circumstances or increased risk)

The reinsured shall timely give notice of changed circumstances that a reasonable and prudent reinsurer would have regarded as material within the meaning of Article 2.2.1.

COMMENTS**1. The scope of the duty of notice**

- C1. This duty exists in respect of all reinsurance agreements (see Article 1.1.1 in connection with Article 1.2.1 Comment 5 as well as Article 2.6.1, noting that the PRICL apply with equal force to both facultative and treaty reinsurance, but PRICL provisions may result in different outcomes depending on type and context of reinsurance). However, the duty to give notice is of most importance in relation to excess-of-loss reinsurance. In this type of reinsurance, the reinsurer is not responsible for making any payments until after the reinsured has paid a minimum threshold of loss. The reinsurer may then reasonably expect to be forewarned when the reinsured is aware of situations that may trigger the reinsurer's obligations. In contrast, quota-share reinsurance involves a proportional sharing of responsibility by reinsured and reinsurer and will less frequently provide situations in which the claims experience may make reinsurance coverage a zero-sum matter. Nonetheless, there may be circumstances in which it would be unfairly surprising to the reinsurer if it was not timely advised of a quota-share reinsured's claims profile that could lead to unexpectedly large reinsurance coverage.

2. The unilateral nature of the duty

- C2. The duty to provide notice of changed circumstances applies only to reinsureds. A reinsurer is entitled to be apprised of developments material to the risks insured in a contract of reinsurance so that the reinsurer can make appropriate plans regarding the setting of reserves and consider its options regarding renewal. The nature of a reinsurance contract is to shift risk from the reinsured to the reinsurer. Because no risk of liability, property damage, disability, loss of life, or professional liability is shifted from the reinsurer, there is consequently nothing that can affect the reinsurer relative to the insured risk that requires notification.
- C3. The reinsured may be interested in the reinsurer's financial strength but this is not a risk encompassed by the reinsurance contract. Rather, it is a risk in any business transaction in that one's trading partner could curtail operations at any moment. Reinsureds protect themselves from such risks not through the allocation of risk in a reinsurance contract but by careful selection of reinsurers and through vigilant monitoring of the economic health of reinsurers. Non-payment by a reinsurer due to financial problems is historically rare and appears to present only a remote danger for reinsureds. In addition, reinsurers typically spread their risks further through retrocession.

3. The parties may vary the degree of notice required

- C4. Specific notice provisions in a reinsurance agreement take precedence over this general duty so long as their literal application does not result in a disproportionate forfeiture of the reinsured's rights.

4. Terminology

- C5. The apt terminology for describing situations requiring notice varies with the type of insurance involved. Liability insurers tend to speak of "claims" (or "suits" or perhaps "demands") while most property, life, and health insurers speak of "losses." The terminology is not particularly relevant to determining the duty to provide notice. Rather, the spirit of this aspect of the PRICL as well as the duty of utmost good faith, requires that a reinsured inform the reinsurer of situations and circumstances which pose a significant likelihood of implicating reinsurance and a request for payment by the reinsurer.

5. The objective "reasonable reinsurer" standard

- C6. The standard for determining when notice is required is an objective one. The test is whether a reasonable insurer in the position of the reinsured would conclude that there is a significant chance of triggering or affecting the reinsurer's obligation. A "significant" chance is more than a trivial or speculative risk of triggering reinsurance coverage but does not require that the implication of reinsurance cover be likely or certain, in a manner akin to the "reasonable and prudent underwriter" test used to apply Article 2.2.1. Regarding the duty of disclosure, one might frame the notice duty as something of a golden rule: the reinsured should inform the reinsurer of a matter or matters if the reinsured would have wanted to be informed, were it in the position of the reinsurer.
- C7. Determining whether there is a significant risk of triggering reinsurance cover will of course be context specific. However, regardless of the type of insurance or underlying circumstances, large claims or losses or a large number of similar incidents are of course strong candidates for prompting the duty of notice unless the defenses to coverage are so strong as to make the risk of coverage remote.

Illustrations

- II. Reinsured A, a life insurer, has many policies in force in a country quite distant geographically from Reinsurer B. The country has substantial ethnic or religious tensions and appears to be on the brink of civil war. Conventional war has not yet erupted but A is aware that two rival ethnic groups have formed gangs and begun engaging in a crime wave of violence and murder. Because of the remoteness of the country and low media scrutiny, the violence has not been publicized. The life insurance policies contain a standard war exclusion but is probably not broad enough to cover informal terrorism, thuggery and politically motivated murder. A has a duty to inform B of the violence. This departure from normality raises the risk of higher reinsurance claims and is the type of information that would impact a reasonably prudent reinsurer. Notice of

the gang activity and the upsurge in the number of deaths is required even if the reinsured intends to aggressively resist payment on the basis of a war exclusion.

- I2. Reinsured A is a Directors' & Officers' (D&O) insurer and enters into a one-year facultative contract with Reinsurer B that begins 1 March and covers a major dot.com company. In April, the stock of the insured company falls 20 percent in the wake of news that its sales have fallen drastically and that this is in direct contradiction to optimistic predictions made in March. In May, a major plaintiff's class action law firm in New York commences litigation, naming the company's officers and directors as defendants and alleging both fraud and negligence. A should give notice to B of these developments because they substantially raise the risk that A will seek reinsurance payments from B. A could argue that at this stage, the lawsuit merely makes allegations and that the odds of a significant plaintiffs' victory are low. Such an argument is not persuasive. The dot.com company forms the entire risk pool of the contract. The large drop in share price creates the risk of a large damage award and because the case has been brought by a prominent law firm that is unlikely to have taken the case without at least some evidence implicating the officers and directors. Although the reinsured may be able to defeat the claim, there may be enormous defense expenses. The reinsured may be able to defeat coverage if there was outright fraud by the insureds – but such a coverage defense is not certain to prevail. Therefore, there is more than a significant risk of triggering reinsurance coverage and notice should be provided.
- I3. Same facts as the previous Illustration except that Reinsured A and Reinsurer B have entered into a contract proportionately sharing risks involving approximately 200 companies that have purchased E&O insurance from A. Six of the smaller companies in the portfolio, amounting to four percent of the risk pool have been sued for "stock drop" claims within the scope of the E&O Coverage provided by A. A need not report this to B. These six lawsuits do not sufficiently increase B's risk exposure to require reporting during the contract period. If the contract is renewed, this information should be disclosed to B even if B does not specifically ask about lawsuits filed since the time of formation of the initial reinsurance contract.

ARTICLE 2.3.4

(Reinsurer rights of inspection)

The reinsurer has the right to inspect the records of the reinsured concerning the insured relationship subject to giving reasonable advance notice. The reinsurer's request must be reasonable regarding time, place and manner of inspection.

COMMENTS**1. A basic right of inspection inures in every reinsurance contract but that right is subject to revision by specific agreement of the parties**

- C1. As previously noted, contractual duties are ordinarily default obligations that may be varied by agreement of the parties. A prospective reinsured may openly state that it is unwilling to provide requested information – but in doing so it, of course, runs the risk that the reinsurer will refuse to do further business with the applicant. However, in the more realistic situation in which a prospective reinsured hopes to obtain reinsurance, the reinsured should be expected to provide, upon reasonable request, documentary information sought by the reinsurer in order for the reinsurer to make a determination as to whether to enter into a reinsurance agreement. See HAMMESFAHR & WRIGHT, Ch 5 (Requirement to Notify the Reinsurer of Losses), Ch 6 (Inspection, and Claims-Cooperation Issues).
- C2. This aspect of reinsurance contracting, like contracting generally, poses questions of efficiency and cost-benefit analysis. A requirement that contracting parties provide documentation imposes additional administrative costs on the contracting process. For that reason, documentation is not required as a default rule. Similarly, a requirement that prospective contracting parties investigate one another raises contracting costs. For insurance, much underwriting is thus done on the basis of answers to questionnaires or applications. The insurer or reinsurer is entitled to rely upon the truthfulness of the answers provided by a prospective policyholder or reinsured in making underwriting decisions. This saves the insurer or reinsurer from the burden of launching a full-scale investigation of the applicant or extensive document review.
- C3. But for reasons of prudence, a reinsurer may wish to investigate the reinsured independently or to require production of documentary information in addition to answers to an application/questionnaire or relying upon the duty of utmost good faith. When a reinsurer decides to seek documentary information from a prospective reinsured, the reinsured – unless clearly refusing – is required to respond in good faith to the request and to produce documentation that is sufficiently complete, accurate, and not misleading.

2. Access to documentation

- C4. A more difficult question is whether a prospective reinsured may demand documentation from a reinsurer regarding solvency, claims practices, or other matters. The prevailing norm is that such information is rarely, if ever, requested and this Article does not set forth any reinsurer obligations regarding inspection of its own documents. If requested, a reinsurer may certainly refuse to provide the information or even use the request as a basis for refusing to sell reinsurance to the requesting party. However, if the reinsurer agrees to provide such documentary information, it has the same duties of providing substantially complete, accurate, and non-misleading documentation as does a reinsured responding to a request by the reinsurer.

3. Common inspection agreements

- C5. Reinsurance contracts typically contain language regarding the reinsurer's rights of inspection concerning the operations of the reinsured and the risks subject to the reinsurance contract. Although there is no one standard inspection clause used in reinsurance contracts, there are a few distinct types of inspection clauses in wide use, which are set forth in Appendix C.

SECTION 4: DUTIES OWED DURING THE CLAIMS PROCESS

ARTICLE 2.4.1

(Claims handling by the reinsured)

The reinsured shall act reasonably and prudently when addressing claims by its insureds that may result in claims for reinsurance coverage.

COMMENTS

1. The dependence of the reinsurer upon the reinsured's claims handling

- C1. Due to the nature of reinsurance, the reinsurer is to a degree dependent on reinsured regarding claims handling and resolution. Even if the reinsurance agreement has a claims handling provision giving rights to the reinsurer or provides for reports to the reinsurer or even the consent of the reinsurer to any settlements, the fact remains that it is the reinsured that is the primary respondent to the claims and has effective control over the defense of claims. Consequently, the duty of utmost good faith requires that the reinsured conduct itself reasonably in the defense and analysis of claims as well as settlement of claims (discussed in Article 2.4.3).

2. The standard for assessing the reinsured's claims handling

- C2. This duty is satisfied if the reinsured behaves in the same manner as it would if there were no reinsurance in place and all defense expenditures or claims payments are made from the reinsured's own funds. The term is not meant literally in that the reinsured is, of course, aware that it has purchased reinsurance and may legitimately consider the existence of reinsurance in structuring its business operations. However, as respects an individual claim or loss, the reinsured should administer the matter as if any payments for defense costs, settlements, or judgments would be made from the reinsured's own funds.
- C3. Under this standard, the reinsured is incentivized to defend claims vigorously if justified, but also to accept when compromise is justified by the merits of the claim. The reinsured must also act with the utmost good faith. Although this Article uses the term "reasonable," in this context unreasonable claims behavior requires something more than mere negligence. A reinsured is permitted to make arguable mistakes while addressing claims without losing reinsurance coverage. But if a reinsured's claims behavior is fraudulent, deceptive, grossly negligent, reckless, self-serving, or intended

to unfairly impose liability upon the reinsurer, the reinsured has violated the duty of utmost good faith.

- C4. Although mere negligence by the reinsured in the defense and settlement of an action is usually not sufficient to strip the reinsured of reinsurance coverage, in extreme cases of unreasonable behavior, the reinsurer may not be bound by the reinsured's settlements or even the outcome of adjudications that could have been avoided by the reinsured and would have been avoided by a reinsured exercising reasonable judgment consistent with the standard of care applicable to insurers defending claims.
- C5. Requiring the reinsured to respond to claims as if it had no reinsurance aligns the reinsured's duties to the reinsurer with a liability insurer's duty to its policyholders. In cases where a liability insurer fails to make reasonable settlement decisions and resolve a claim within policy limits, the insurer is typically responsible for paying not only its policy limits but the amount of any judgment against the policyholder in excess of policy limits. The rationale for this remedy is to make the insurer approach settlement opportunities as if any resulting judgment would be paid solely by the insured without regard to policy limits. This encourages the insurer to accept reasonable settlement demands at or below the policy limits.

Illustrations

- I1. A prominent movie director is sued for alleged sexual harassment and provides notice to Reinsured A, the director's EPL (employment practices liability) insurer. A investigates and finds the claim appears to be meritless. The plaintiff's account of two of the incidents is contradicted by security camera footage. A third alleged incident supposedly took place at a time when the plaintiff and defendant were in different cities, which can be documented by airline tickets, hotel receipts, and security camera footage. The fourth incident of purported harassment allegedly took place at a company retreat. All eyewitness testimony supports the defendant but most of the witnesses are company employees. However, two of the witnesses were a motivational speaker and chaplain present at the retreat. The policyholder demands a confidential multi-million-dollar policy limits settlement to keep the matter from attracting media coverage. If A pays policy limits in settlement, B may correctly contend that A has acted unreasonably. Where a claim appears objectively meritless, it would be a breach of the duty of good faith for the reinsured to settle without significant resistance and pass the loss on to the reinsurer.
- I2. Reinsured A, a general liability insurer, has a large corporate policyholder sued for defamation by a competitor that claims its product was disparaged by the policyholder. The defamatory conduct alleged did take place but despite the negative statements, the plaintiff's product sales have skyrocketed, making it difficult to determine the amount of damage, if any, suffered by the plaintiff. In the absence of facts counseling to the contrary, A would be acting unreasonably to pay policy limits in settlement of the claim without first testing the *bona fides* of the plaintiff's damages. If A makes an immediate policy limits settlement without engaging in adequate investigation, discovery, and

defense of the damages portion of the plaintiffs' claim, B has grounds for resisting payment due to unreasonable claims handling behavior by A.

- I3. Same facts as in the previous Illustration, except that A not only contests damages but also disputes the allegations of product disparagement defamation, even though the policyholder has admitted the misconduct and the evidence clearly established that A's policyholder made untrue, disparaging statements about the plaintiff's product that do not fall within any immunity provided by the applicable law. A incurs substantial defense costs, which are within the scope of the reinsurance contract, on the liability question and is sanctioned by the presiding court for making a frivolous defense. (See 28 USC § 1927)(US law providing for monetary sanctions, including imposition of counsel fees award on a party who vexatiously delays or multiplies court proceedings); Fed R Civ P 11 (US rule of civil procedure providing for sanctions where a claim is made by a pleading, motion, or other paper that lacks evidentiary support and is reasonable under the law); Fed R Civ P 37(US rule providing for the imposition of sanctions where a litigant abuses the civil discovery process). Many jurisdictions also provide tort causes of action for malicious prosecution and abuse of process that could be applicable in such situations.) A pays these sanctions. The matter is eventually settled for a relatively small amount of damages paid to the plaintiff. A seeks reimbursement from B. B can prevail in its refusal to pay for the payments attributable to sanctions and A's counsel fees disputing the clear liability of its policyholder. The expenditure of these defense funds and the incurring of sanctions resulted from unreasonable claims behavior by A.
- I4. Reinsured A, an automobile insurer, has a policyholder sued by an injured pedestrian. The liability of A's policyholder is clear, but A determines that the plaintiff is not badly injured and offers only a small settlement, assuming that the plaintiff will become weary of pressing the claim and eventually accept the small settlement offer. Instead, the plaintiff continues to litigation. By the time trial takes place two years later, doctors have discovered that plaintiff's injuries are much worse than initially sought, including cognitive degeneration from a concussion incurred in the collision. A increases its settlement offer, but it is still objectively low in relation to plaintiff's injuries and well below the policyholder's automobile and umbrella liability policy, which was also issued by A. Trial results in a multi-million judgment against A's policyholder that is well in excess of the combined policy limits. A pays policy limits and the excess judgment and then seeks payment from B. A's claims behavior has been unreasonable and subjects B to the relevant remedies provisions of the PRICL.
- I5. Same facts as the previous Illustration, except that A makes a fair settlement offer at the outset and then defends the policyholder aggressively after the offer is refused. When doctors find out that plaintiff's injuries are more serious than expected, A increases its settlement offer to the combined policy limits, but the plaintiff rejects the offer. Trial results in the same multi-million judgment in excess of policy limits. A pays the limits and excess judgment and then seeks payment from B. A has behaved reasonably as if it had no reinsurance in place.

Absent other facts establishing a violation of A's duties to B, B is not entitled to the remedies provided by the PRICL and must make payment to A.

3. The duty to seek funds from third parties

- C6. As part of its obligation to process claims prudently, the reinsured should make reasonable efforts to obtain indemnity, contribution, salvage or recovery from third parties who have contributed to creating the reinsured's liability.

Illustrations

- I6. Reinsured A, a commercial property insurer, pays USD 10 million in connection with a large fire in a newly completed warehouse. Investigation reveals that the fire was caused by faulty wiring attributable to an electrical subcontractor that wired the warehouse. The subcontractor is solvent and has a large amount of liability insurance. A declines to pursue a subrogation action on behalf of itself and the warehouse owner, but does seek payment from Reinsurer B for the loss. A has breached its duty to B by failing to take reasonable measures to recoup the loss from the tortfeasor electrical subcontractor. Under applicable law, the general contractor or others may also be liable. Remedies available to B are subject to Article 3.1.
- I7. Same facts as in the previous Illustration, except that the liability case against the electrical subcontractor is estimated to have less than a fifty percent (50%) chance of success and will cost at least USD 1 million to litigate to conclusion because of the need for expert witnesses and a considerable investment of time by A's lawyers in pursuing the potential subrogation claim. Although A perhaps should at least make the claim or file suit in order to seek a settlement from the electrician's liability insurer, A can colorably claim that it has not acted unreasonably and that it would make the same decision in the absence of available reinsurance. A is entitled to payment from B pursuant to the reinsurance contract.
- I8. Same facts as in the previous Illustration, except that the estimated chance of success in a suit against the electrical subcontractor is less than twenty percent (20%). A's decision not to invest resources in pursuit of a subrogation claim that is so uncertain to succeed is reasonable under the circumstances. A is clearly entitled to payment from B pursuant to the reinsurance contract.
- I9. Same facts as in the previous Illustration, except that A is a homeowner's insurer, the amount of loss was USD 100,000 and the alleged tortfeasor electrician is a small business with no liability insurance. A decides not to pursue subrogation. A's decision appears reasonable in light of the relatively low possibility of recovery in relation to investment of resources by A. A is clearly entitled to payment from B pursuant to the reinsurance contract.

4. Limitations on claims resolution authority

- C7. A reinsured shall observe any claim authority limit established by the reinsurance agreement or other agreement or course of dealing established between the reinsured and the reinsurer. The reinsured should also reasonably comply with the claims handling requirements of the relevant jurisdiction in order to avoid or minimize extra-contractual obligations. This includes, as necessary, shouldering defense obligations to the policyholder, complying with the fair claims handling laws of the relevant jurisdiction, and complying with any general consumer protection or fair dealing law of the relevant jurisdiction.

5. Sharing of information

- C8. As a general matter, the reinsured is required to share information sought by the reinsurer if it is relevant to the claims at issue or the construction of the reinsurance agreement and includes providing information concerning: (a) amounts claimed; (b) the amounts reserved; (c) amounts of loss adjustment expenses; (d) claims personnel with decision-making authority; (e) expert reports; (f) policy wording and other relevant documents; (g) explanation of the reinsured's coverage position and assessment of exposure; (h) claims handling activities and decisions; (i) discharge of the reinsured's duty of good faith owed to insureds; (j) recoveries obtained or pursued; (k) litigation documents and settlement agreements; and (l) proof of loss or claim and payment.

6. Reasonable allocation of claims

- C9. Reasonable allocation of claims requires the reinsured to allocate claims to particular policies or time periods according to an objective principle apt for the claims in question. The reinsured breaches its duty of utmost good faith if its allocation decisions are made primarily in order to maximize reinsurance coverage without objectively reasonable bases for allocating claims payment to particular policy periods. As a practical matter, reinsureds will often be aware that particular allocation decisions may affect reinsurance coverage. If a reinsured selects one of two or more allocation methods that increases available reinsurance, this does not, standing alone, violate the reinsured's duties or constitute improper claims processing. However, if the allocation method chosen is not colorable or is shown to have been chosen primarily to maximize reinsurance, the reinsured is in breach of its duties to the reinsurer.

7. Applicability of a claims control clause

- C10. Where the reinsurance agreement contains a claims control clause, both reinsured and reinsurer shall conform to the terms of the clause in good faith.

8. Extra-contractual liability

- C11. A reinsurer is generally not responsible for losses in excess of the reinsured's policy limits or for the reinsured's extra-contractual liability to a policyholder or others unless the reinsurer's conduct played a contributing role to the reinsureds' extra-contractual liability or liability in excess of policy limits. See Articles 2.4.4 and 2.4.5 below.

ARTICLE 2.4.2*(Notice of claims)*

The reinsured shall give the reinsurer adequate and timely notice of claims subject to the reinsurance contract and of circumstances that pose a significant chance of resulting in reinsurance coverage.

COMMENTS**1. The rationale for notice**

- C1. The duty of utmost good faith for a reinsured includes the duty to provide fair warning to the reinsurer of likely future demands for payment due to the reinsured's claims responsibility. This enables the reinsurer to make finance and reserving plans and to consider how closely to monitor the situation, consistent with any claims control clause in the reinsurance contract or Article 2.4.1.

2. The triggering of the notice obligation

- C2. Notice determinations should be made on the basis of the reinsured's objectively reasonable analysis of its claims activity in light of the nature of the affected reinsurance contract. A reinsured is not required to give notice of every claim for which large damages are alleged or every category of claims that poses only a remote risk of class action or mass tort status. The reinsured is, however, required to provide notice where the reinsured knows there is a substantial probability that it will be seeking reinsurance payments in connection with a particular policy, treaty, claim, or risk.

Illustrations

- I1. Reinsured A holds a facultative certificate with Reinsurer B which provides for coverage on an excess-of-loss basis after A's claims payments exceed USD 5 million regarding an identified group of general liability policies. One of A's policyholders supplies component parts for a medical device that has recently been called defective in the media. Seven lawsuits have been filed, with each of the plaintiffs claiming the medical device was defective and has caused serious injury. The policyholder's corporate counsel advises A that this is probably "just the tip of the iceberg." A must give prompt notice of the situation to B. These developments that post-date contract formation suggest a much higher risk exposure and likelihood of payments by both A and B than was originally anticipated.
- I2. Same facts as the previous Illustration, except that there is only one lawsuit to date that was filed in a jurisdiction known for its swift disposition of cases. Corporate counsel and policyholder defense counsel (provided for by A) believe that other potential plaintiffs are refraining from suit until they see the outcome of the one case. Defense counsel has investigated and concluded that media articles were overwrought and believes the case is defensible on both the

question of product defect and on the question of causality and damages. The plaintiff has a history of significant medical problems. A determines that it need not provide notice of the lawsuit to B. Fast-track trial ensues and results in a defense verdict, vindicating A's decision that notice was unnecessary. B has no remedies under Article 3.1.

- I3. Same facts as the previous Illustration, but the fast-track trial results in a large plaintiff's verdict. Despite this, A's decision to refrain from notice during the pendency of the trial appears reasonable under the circumstances. A may, however, be required to notify B of the large verdict and its implications regarding risk of additional liability of this type and potential remedies.
- I4. Same facts as the previous Illustration but in addition, as a reaction to the first plaintiff's large verdict, two dozen new lawsuits are filed against A's policyholder. A now has a duty to notify B. Even if some or all of these new lawsuits result in defense verdicts, the new lawsuits reflect a wave of such claims that increases the risk to B.

ARTICLE 2.4.3

(Follow-the-fortunes and follow-the-settlements)

The reinsurer shall follow the fortunes of the reinsured and follow the settlements of the reinsured by reimbursing the reinsured for payment of loss covered by the reinsurance contract and arguably covered by the primary insurance contract.

COMMENTS

1. Clarifying the terminology of follow-the-fortunes and follow-the settlements

- C1. Some degree of confusion attends this area of reinsurance in that courts and even industry insiders display different understandings of the terms and concepts. Courts, particularly in the United States, are often criticized as incorrectly collapsing the concepts into one and adopting a view of the concept that gives insufficient consideration to the interests of reinsurers. The follow-the-fortunes and follow-the-settlements principles are similar but distinct.
- C2. The follow-the-fortunes concept provides that reinsurer follows the insurer's fortunes under the latter's insurance policies, subject to the stated exclusions and limitations in the reinsurance agreement. Unless there has been misconduct by the reinsured, the reinsurer is bound by the claim results to which the reinsured is bound.
- C3. The follow-the-settlements term is used to describe the reinsurer's obligation to accept the settlements made by the reinsured (as well as judgments against it pursuant to the follow-the-fortunes principle). Under either circumstance, the reinsurer must pay accordingly. See STARING AND HANSELL § 18:1; *Reinsurance: Indemnifying Insurers for Insurance Losses*, in Strain 25 et seq. See also O'NEILL AND WOLONIECKI 5-007, 5-

012; FERGUSON 60; See generally CARTER ET AL, *Reinsurance*, Ch 3 (Principles and Practice of Reinsurance), Ch 4 (Legal Principles Applying to Reinsurance Contracts); EDELMAN & BURNS 4.01-4.93 (discussing obligations of the reinsurer, including follow-the-fortunes principle); HAMMESFAHR & WRIGHT.

- C4. The more heavily litigated follow-the-settlements concept has been described as making reinsurers “obliged to indemnify the reinsured in the event that they settle a claim by their underlying insured provided that the claim as recognized by them falls within the risk covered by the policy of reinsurance as a matter of law, and provided also that in settling the claim, the reinsured has acted honestly and has taken all proper and businesslike steps in making the settlement”. See EDELMAN & BURNS 4.13, citing *Insurance Co of Africa v Scor (UK) Reinsurance Co Ltd* [1985] 1 Lloyd’s Rep 312 and *Wasa International Ins Co v Lexington Ins Co* [2010] 1 AC 180, [2009] 2 Lloyd’s Rep 503, para 35.
- C5. Follow-the-settlements refers to the reinsurer being bound by the negotiated resolution of claims by the reinsured so long as these settlements meet the criteria set forth above in that the settlement is not: collusive; fraudulent; clearly outside of coverage; or beyond the amount of limits set forth in the agreement; unreasonable in amount and terms due to gross negligence, recklessness, or failure to act with utmost good faith toward the reinsurer.
- C6. One court differentiated the concepts by stating that the term follow-the-fortunes “more accurately describes the reinsurer’s obligation to follow the reinsured’s underwriting fortunes, whereas [follow-the-settlements] refers to the duty to follow the actions of the reinsured in adjusting and settling claims.” See *North River Ins Co v Employers Reinsurance Corp*, 197 F Supp 2d 972, 978 n. 1 (SD Ohio 2002). The principle of binding the reinsurer to the outcomes experienced by the reinsured is summarized in one leading treatise as having the reinsurer bound to follow the settlements of its reinsured subject to two conditions:
- 1) As a matter of fact, that in settling the claim the reinsured had acted honestly and had taken all proper and businesslike steps in making the settlement.
 - 2) As a matter of law, that the claim paid by the reinsured to the original insured falls within the risks covered by the policy of insurance.
- C7. If these two provisos are satisfied, the reinsurer is bound to follow the reinsured’s settlement (but only up to the reinsurance policy limit), where there has been either a compromise of liability or quantum or both. In particular, the reinsurer cannot seek to go behind the reinsured’s settlement of the original insured’s claims and it must rely on the reinsured’s professionalism.
- C8. See CLYDE & CO 1.85, 1.86 at 1-18 (italics in original), discussing *Insurance Co of Africa v SCOR UK Reinsurance Co Ltd* [1985] 1 Lloyd’s Rep 312 (Court of Appeal). In *SCOR*, as in many cases, the reinsurance contract in question contained an express follow-the-settlements clause, which is common in reinsurance contracts.

2. Follow-the-fortunes and follow-the-settlements as a default rule as well as a typical clause in reinsurance contracts

- C9. Because such clauses are so common and because the follow-the-fortunes and the follow-the-settlements principles have been so widely applied for such a long time, they should be viewed as being a part of all reinsurance agreements unless the parties agree otherwise and this is clearly stated in the reinsurance policy. In other words, the follow-the-fortunes and follow-the-settlements principles apply to all reinsurance contracts unless otherwise stated. But like most contract rules, this rule is a default rule that can be altered by the parties as part of the contracting process. In discussing the follow-the-settlements concept, care must be taken because the obligation is normally established by specific language in the reinsurance contract. See STARING AND HANSELL § 18:3, setting forth more than 20 alternative phrasings and § 18:6, discussing court rulings concerning particularly worded clauses. In addition, these treatise authors note (§ 18:2) that there is division of judicial and scholarly opinion as to whether a reinsurer must follow the reinsured's settlements in the absence of such a clause.
- C10. This Article of the PRICL adopts the position that even in the absence of specific follow-the-settlements language in a contract, a reinsurer must follow the settlements of the reinsured up to the limits provided by the reinsurance contract so long as payments are made honestly and in good faith and the reinsured's decision regarding any coverage disputes with the underlying insured is reasonable. The PRICL takes the view that follow-the-settlements contract language is so pervasive and the concept of such long-standing and relevance to the function of reinsurance that it is an implied term of all reinsurance contracts. However, because the provisions of the PRICL are default rules unless otherwise stated, the contract parties may adopt whatever follow-the-settlements language they wish, including a provision removing the follow-the-settlements obligation that would otherwise presumptively exist.
- C11. Absent a provision in the insuring agreement negating these obligations, a reinsurer is presumptively bound to cover settlements made by the reinsured or the outcome of a claim, provided that the reinsured acted reasonably. See, e.g., *Reliastar Life Ins Co v IOA Re, Inc*, 303 F3d 874, 878 (8th Cir 2002)(applying Minnesota law)(doctrine essentially "posits that if the cedent has acted in good faith in handling the claims presented to it and in providing coverage of the claims," the reinsurer may not "second guess" the coverage decisions of the reinsured); *North River Ins Co v CIGNA Reinsurance Co*, 52 F3d 1194 (3d Cir 1995)(applying Ohio law as to insurance questions and New York law on reinsurance issues)(largely binding reinsurers to adjudication and settlement outcomes of reinsureds); *Unigard Sec Ins Co v North River Ins Co*, 4 F3d 1049 (2d Cir 1993)(applying New York law)(rejecting the reinsurer's late notice defense in a case involving the reinsured's asbestos liability pursuant to the Wellington agreement regarding insurance coverage for asbestos-related claims but finding the reinsurer not liable for coverage of reinsured's disputing costs in excess of policy limit).

3. To be subject to reimbursement, a reinsured's payment must fall within the scope of the reinsurance contract

- C12. To get the benefit of the follow-the-settlements concept, the reinsured's payment must be one that "fall[s] within the policy of reinsurance" which in turn means that the payment must be within the scope of the insuring agreement between the reinsured and its underlying insured. See EDELMAN & BURNS 4.20. This does not mean that the reinsured must prevail in a *de novo* determination of the confines of coverage. The reinsurer cannot require the reinsured to prove that the assured's claim was in fact covered by the original policy. But the reinsured is required to show that the basis upon which it settled it was one which fell within the terms of the reinsurance. See *Assicurazioni Generali SpA v CGTU International Insurance plc* [2004] Lloyd's Rep IR 457; EDELMAN & BURNS 4.01-4.93. A reinsurer is not required to pay for uncovered claims. A reinsurer is not liable to compensate a reinsured that settles a claim that is clearly outside the scope of the insurance that is the subject of the reinsurance. See OZOG ET AL at 94.

Illustrations

- I1. Reinsured A and Reinsurer B enter into a proportional reinsurance contract covering the general liability exposure of a major U.S. automobile dealer. The automobile dealer's insurance issued by the reinsured expressly excludes coverage for punitive damages. The automobile dealer is sued in connection with an exploding gas tank that incinerates the occupant of the vehicle, a 60-year-old day laborer. Litigation ensues. During the course of the litigation it is discovered that the automaker knew of the dangers of the gas tank but continued to sell vehicles with this problem and provided no warning. After trial, the estate of the victim obtains a judgment denominated as USD 1 million in compensatory damages and USD 100 million in punitive damages. B is responsible only for its share of the compensatory damages award.
- I2. Same facts as the previous Illustration except that while the defendant's appeal from the USD 101 million verdict is pending, A settles the claim with the victim's estate for USD 10 million. Because the settlement obviously includes payment for punitive damages well above the USD 1 million of compensatory damages awarded, B is responsible only for the share of the settlement linked to the compensatory damage award. See, e.g., *American Insurance Co v North American Co for Property & Casualty Ins*, 697 F2d 79 (2d Cir 1982)(applying New York law)(reinsurer was not responsible for the punitive damages portion of the settlement where this was clearly excluded by reinsurance certificate).
- I3. Reinsured A and Reinsurer B enter into an excess-of-loss reinsurance contract covering an automobile manufacturer that provides that B will be responsible for liability in excess of USD 5 million on any single claim. The automaker is sued in another exploding gas tank case. Eager to avoid a large punitive damages verdict, A quickly settles the case for USD 2 million. B is not liable for any payments to A because A's payments to the automaker's victim do not exceed the attachment point of the reinsurance contract. See, e.g., *Michigan Millers Mutual Ins Co v North American Reinsurance Corp*, 452 NW2d 841

(Mich. Ct App 1990)(reinsurer was not liable for payments below attachment point).

- I4. Reinsured A, a general liability insurer, enters into a proportional reinsurance contract with Reinsurer B. A's policyholder, the owner of a bar/restaurant, is sued by the estate of a patron who was permitted to consume excessive amounts of liquor at the bar and then drove off the road to his death after leaving the bar or caused the death of other motorists or pedestrians after departing the bar. Because general liability policies uniformly contain a clear liquor liability exclusion routinely enforced by courts, there is effectively not even a potential for coverage in this case. Consequently, the liability insurer need not even defend the claim. Nevertheless, A negotiates a USD 500,000 settlement with the estate of the patron. The settlement payment would be gratuitous and B is not responsible for contributing to it. B is not bound by a settlement like this that so clearly exceeds the scope of the insurance policy that is the subject of the reinsurance.
- I5. Reinsured A and Reinsurer B enter into an excess-of-loss reinsurance contract concerning A's general liability coverage of a large pharmaceutical company. The attachment point is USD 10 million with reinsurance contract policy limits of USD 25 million. The policyholder company's new drug is popular and widely prescribed by physicians. Then serious side effects are discovered that lead to a large class action lawsuit. The case proceeds to trial and results in a USD 100 million judgment against the drugmaker. B is responsible only for USD 25 million but not the USD 90 million that exceeds the attachment point.
- I6. Same facts as the previous Illustration except that A is able to settle the class action lawsuit for USD 50 million. B is responsible only for USD 25 million but not the amount of liability that exceeds the policy limits. In this case, the reasonableness of A's conduct in settling the case in order to avoid larger liability is irrelevant to B's financial obligations under the reinsurance contract. See, e.g., *Bellefonte Reinsurance Co v Aetna Casualty & Surety Co*, 903 F2d 910 (2d Cir 1990)(holding that the follow the fortunes doctrine does not require the reinsurer to pay an amount in excess of reinsurance agreement limit in case where the reinsured's total liability for covered matter, including defense costs, exceeded reinsurance limit).

4. Back-to-back coverage

- C13. The PRICL does not address what is commonly termed "back-to-back" coverage in reinsurance. Although the back-to-back concept is often associated with the follow-the-fortunes and follow-the-settlement concepts, they are distinct. The question of whether reinsurance coverage is presumed to have contours congruent with the underlying insurance may arise. In the UK and EU, such congruent coverage is generally referred to as "back-to-back coverage." O'NEILL AND WOLONIECKI 4-070. In the US, such congruent coverage is more likely to be described as seamless or "following form," although the latter term is also used to describe the congruence of excess insurance with the policy or policies underlying the excess policy. Unless the reinsurance contract expressly provides to the contrary, reinsurance is presumably back-to-back to,

congruent with, or following form to the insurance policies that are reinsured. See *Vesta v Butcher* [1989] 1 Lloyd's Rep 331. Any other default rule would undermine the risk management objectives and predictability of a reinsurance arrangement. Where a reinsurer does not want to provide coverage as broad as that of the reinsured's policy or policies, it is the reinsurer's burden to so state in the facultative certificate or treaty. Treatise authors O'NEILL AND WOLONIECKI criticize the *Vesta v Butcher* opinion of Lord Griffiths as "too simplistic." See O'NEILL & WOLONIECKI 4-070. But a full reading of their criticism is largely based on the contention that whether coverage is back-to-back depends on the intent of the parties and the specifics of the reinsurance contract. See O'NEILL & WOLONIECKI 4-070 and § 4-071. This view – that specific language in a reinsurance contract should be honored – is completely consistent with Lord Griffiths' view in *Vesta v Butcher* that a "reinsurer could of course make a special contract with an insurer and agree only to reinsure some of the risk covered by the policy of insurance, leaving the insurer to bear the full costs of the other risks." However, the observation of the court that this type of reinsurance contract would be "wholly exceptional" and a "departure from the normal understanding of the back-to-back nature of reinsurance" and thus should be "spelt out in clear terms" is completely reconcilable with the O'NEILL & WOLONIECKI view that reinsurance agreements containing language rejecting or limiting back-to-back cover should be enforced if sufficiently clear. Perhaps less easily reconcilable is Lord Griffiths' statement that he doubted "if there is any market" for reinsurance that is not back-to-back, an empirical assumption challenged by the treatise authors. See O'NEILL & WOLONIECKI 4-071 (noting that use of term "as original" in reinsurance contracts creates back-to-back obligation and suggesting that presence and frequent use of the "as original" term implies that back-to-back coverage is not automatically presumed). There is almost always some niche market for insurance products that differ from the mainstream just as there may be difficult risks for which insurers or reinsurers are unwilling to provide their typical breadth of coverage. But this does not negate the norm – which is a presumption of back-to-back coverage unless otherwise specified.

5. The binding effect of adjudication

- C14. Even if an insured judgment against the policyholder may be considered incorrect (e.g. the policyholder should not have been held liable) or excessive (e.g. the amount of the verdict and judgment is beyond what many would consider a reasonable award in light of the injuries claims), the reinsurer is generally bound by the adjudication results unless the reinsured's handling of the matter was sufficiently unreasonable (e.g. allowing judgment by default in the face of a serious claim) as to violate the duty of utmost good faith and make it unfair to bind the reinsurer to the outcome. Following the fortunes of the reinsureds includes coverage of the reinsured's disputing costs and extra-contractual liability unless the reinsurance agreement specifically provides to the contrary.

6. The standard of reasonable claims behavior

- C15. In applying the reasonable claims behavior standard, it should be noted that a reinsurer wishing to avoid being bound by a reinsured's coverage decisions, settlements, or adjudicatory outcomes must demonstrate more than mere negligence to support a claim of unreasonable behavior by the reinsured. Rather, in situations implicating follow-the-

settlements principles, the reinsurer must show that the reinsured acted fraudulently, deceptively, with gross negligence, recklessness, or other behavior violating the reinsured's duty of utmost good faith. See *Reliastar Life Ins Co v IOA Re, Inc*, 303 F3d 874, 877-78 (8th Cir 2002); *American Bankers Ins Co of Florida v Northwestern National Ins Co*, 198 F3d 1332, 1336 (11th Cir 1999)(negligence alone by the reinsured does not establish bad faith); *North River Ins Co v CIGNA Reinsurance Co*, 52 F3d 1194, 1216 (3d Cir 1995)(applying New York law on reinsurance issues, where it was held that the reinsured must exhibit "an extraordinary showing of a disingenuous or dishonest failure to carry out a contract" to prevent application of follow-the-fortunes principle).

- C16. Likewise, a reinsurer is not bound by settlements between a plaintiff and the reinsured that are fraudulent or the product of collusion between the plaintiff and the reinsured. Similarly, a settlement that is objectively unreasonable (e.g. paying the plaintiff USD 1 million in a case where the policyholder's liability is doubtful or where only minor injury occurred) is not one that must be followed by the reinsurer.
- C17. In determining what constitutes an objectively unreasonable settlement, due regard should be given to the risks faced by the reinsured if it does not settle, including bad faith suits by policyholders, investigation and punishment by regulators, the risk of worse outcomes at trial, and increased disputing costs. If it cannot be said with positive assurance that after consideration of these factors, no reasonable person would support the amounts paid in settlement, the settlement should generally be considered sufficiently reasonable in amount and terms.
- C18. Except to the extent that a reinsured's settlement is outside the scope of coverage, exceeds the amount of insurance purchased, is objectively unreasonable, or results from fraud, collusion, or other bad faith by the reinsured, the reinsurer is bound by the settlement. If the claim is adjudicated, the result is also binding on the reinsurer unless it can be demonstrated that the reinsured acted in bad faith in defending or failing to defend the claim.

ARTICLE 2.4.4

(Cooperation in claims handling)

The parties shall reasonably cooperate regarding all aspects of the handling and administration of reinsurance claims.

COMMENTS

1. The general duty of cooperation

- C1. Parties to contractual agreements are required to cooperate. Although there may of course be genuine disputes regarding their obligations, neither party should engage in action or inaction that deprives the other party of the benefit of the bargain. This is the essence of ordinary good faith. The duty of utmost good faith requires even greater

fidelity to this commitment. A corollary of this obligation is a duty to cooperate that must be mutually observed by the parties.

- C2. This Article sets forth only a general duty of cooperation that applies to claim processing and administration generally and should not be viewed as superseding any specific requirements of a claims cooperation clause that may be (and normally is) included in the reinsurance contract.

2. The requirements of cooperation for the reinsured

- C3. Regarding cooperation in claims processing, for reinsureds, this generally means:

- a) providing the reinsurer with reasonable prompt notice of claims that may implicate the reinsurer's obligations;
- b) providing the reinsurer with adequate information regarding the nature and magnitude of the claim and resulting settlements or judgments;
- c) if requested, providing the reinsurer with additional reasonable documentation supporting the reinsured's description and characterization of claims;
- d) administering the claims in a reasonable manner, including refraining from unreasonable allocation that would have the effect of requiring the reinsurer to provide more coverage of longer-tail matters than is required by the policy period and terms of the reinsurance agreement; and
- e) complying with applicable claim authority limits established by the reinsurance agreement or other specific agreements or course of dealing between the reinsured and the reinsurer.

3. The requirements of cooperation for the reinsurer

- C4. For the reinsurer, the duty of cooperation in claims processing generally entails:

- a) promptly acknowledging claims and informing the reinsured of any objections to coverage and any information or documentation sought by the reinsurer;
- b) refraining from imposing unreasonable informational and documentary duties upon the reinsured;
- c) refraining from taking unreasonable positions regarding the allocation of longer-tail claims that would unreasonably curtail coverage; and
- d) reasonably prompt payment in connection with covered claims that result in liability through adjudication or reasonable settlement.

4. The consequences of failure to cooperate

- C5. The consequences of the failure of a contract party to cooperate shall be determined according to the facts and circumstances of each case, with particular attention paid to the consequences visited upon one party by another's lack of cooperation.

ARTICLE 2.4.5

(Timely payment of reinsurance claims and resolution of disputes)

Upon proper presentation of a claim by the reinsured for payment, the reinsurer shall make reasonably prompt payment of amounts to be paid on a claim to the reinsured pursuant to the contract. The parties may specify the precise terms and timing of payments.

COMMENTS

1. Proper presentation

- C1. Proper presentation of a request for payment means an adequately documented request by the reinsured supported by sufficient proof of payment (or obligation to pay) claims. The reinsured is required to demonstrate with reasonable certainty that it has paid insurance claims that are subject to a reinsurance contract with the reinsurer from which payment is sought.

2. The parties may specify the precise terms and timing of payments.

- C2. Although there is a general reinsurance norm requiring timely payment of obligations, there is no widely established specific time limit (e.g. within 30 days of notification, within 10 business days of verification). Consequently, parties to a reinsurance contract wishing a more concrete standard than the general obligation to make timely payment upon reasonable request may elect to establish more concrete and specific procedures and deadlines regarding payment. To the extent the parties do not have a specific agreement, payment may be governed by established courts of performance or course of dealing between the parties or by custom and practice of the particular reinsurance market. In the absence of contrary information, payment is subject to relevant terms of the PICC.

3. The importance of timely payment

- C3. Notwithstanding that reinsurers will generally earn higher profits by paying claims later rather than earlier, reinsurers are under a good faith obligation to pay properly presented claims as promptly as feasible, particularly when there are not significant disputes regarding coverage. Although there is no hard-and-fast timeline for payment to the reinsured, this should generally be done at the speed with which the reinsurer pays its other contracting partners in cases where there are not disputes surrounding entitlement to payment or amount of payment.

- C4. The respective good faith duties of the reinsurer and the reinsured logically compel both to attempt to process claims and resolve disputes promptly to the extent possible. In addition, the reinsured – and the reinsurer vested with rights of consent or control over resolution of claims involving the reinsured – should also attempt to resolve claims by or against the policyholder as promptly and efficiently as feasible. Undue delay or multiplication of disputes imposes costs not only on the reinsured and reinsurer but also on third parties and the judicial and risk management systems. Minimizing these delay and disputing costs, when this can be done without sacrificing the parties' respective contractual rights, benefits society and should be the goal of reinsurer and reinsured.

Chapter 3

REMEDIES

ARTICLE 3.1

(Remedies for breach of contract)

(1) If a party breaches the contract, an aggrieved party is entitled to claim

(a) performance in accordance with Chapter 7 Section 2 PICC;

(b) damages in accordance with Chapter 7 Section 4 PICC.

(2) An aggrieved party may terminate the contract if it cannot reasonably be expected to uphold the contract.

COMMENTS

1. Relation to the PICC

- C1. The approach taken in Article 3.1 largely follows the approach of Chapter 7 PICC. However, the rule on termination in Article 3.1 paragraph (2) deviates from and takes precedence over Article 7.3.1 PICC.
- C2. Article 3.1 uses the term “breach of contract” rather than the term “non-performance”. The term “breach of contract” clearly includes defective performance and late performance as well as a total failure to perform whereas it is doubtful as a matter of linguistics whether the term “non-performance” would include defective and late performance. Considering the way Article 7.1.1 PICC defines the term “non-performance”, it is synonymous with the term “breach of contract”.
- C3. The provisions contained in Chapter 7 Sections 2 and 4 PICC are set forth in Annex 1 (Chapter 7 Section 2 PICC) and Annex 2 (Chapter 7 Section 4 PICC) attached to these Comments.

2. Remedies in general

- C4. Article 3.1 does not distinguish between different types of breaches. Hence, the remedies provided govern any breach of contractual duties stipulated by the PRICL and the contract itself.
- C5. Article 3.1 does not provide remedies for breaches of pre-contractual duties. Remedies for breach of the pre-contractual disclosure duty (Article 2.2.1) are provided in

Article 3.2. Remedies for breach of other pre-contractual duties are provided by the PICC, e.g. Article 2.1.15 PICC (concerning the duty to negotiate in good faith), Article 2.1.16 PICC (concerning the duty of confidentiality), Article 7.4.1 PICC (concerning the right to damages in general and including damages for breach of pre-contractual duties).

- C6. In contrast to Article 3.2, the remedies provided in Article 3.1 are available to both reinsurer and reinsured, whichever is the aggrieved party.
- C7. Article 3.1 paragraph (2) is based on the assumption that both parties to the contract have an interest in upholding it regardless of the breach. Therefore, the contract shall only be terminated where the breach is such that the other party cannot reasonably be expected to uphold the contract. In any other cases, claims for damages and performance are sufficient remedies.
- C8. Article 3.1 does not provide the aggrieved party with a right to adjust the contract. An adjustment can be made according to the terms of the contract or by an ad hoc agreement of the parties.
- C9. The list of remedies provided in Article 3.1 is comprehensive and binding upon a court or an arbitral tribunal, as the case may be. The parties may deviate from Article 3.1 in the contract or allow for deviations by the arbitral tribunal (e.g. by agreeing on an ex aequo et bono element in an arbitration clause).
- C10. The remedies provided in Article 3.1 are not mutually exclusive and need not be pursued in any particular order. The aggrieved party may rely on one remedy exclusively, e.g. when it claims damages only. It may also combine remedies in an appropriate manner, e.g. when it claims specific performance as well as damages to compensate for the delay prior to performance.
- C11. In accordance with the principle of good faith as provided in Article 1.7 PICC and the principle of utmost good faith as provided in Article 2.1.2, a party entitled to a remedy under Article 3.1 may be restricted when exercising such right. E.g. a party may not be able to terminate the contract under Article 3.1 paragraph (2) if it has not pursued that right within a reasonable time. Generally speaking, the concept of inconsistent behavior (*venire contra factum proprium*; cf. Article 1.8 PICC) applies to the exercise of such remedies. For example, a party may not exercise a remedy for breach to the extent such breach was caused by its act or omission or by another event for which it bears the risk. See Article 7.1.2 PICC (Interference by the other party).
- C12. Questions concerning limitation are governed by Chapter 10 PICC. In particular, the general limitation period of three years as provided in Article 10.2(1) PICC applies to all remedies.

3. Right to performance (Article 3.1 paragraph (1)(a))

- C13. Article 3.1 paragraph (1)(a) grants the right to performance and thereby refers to Chapter 7 Section 2 PICC. In reinsurance contracts, the main duties of the parties are of a monetary nature. Accordingly, Article 7.2.1 PICC (Performance of monetary

obligation) grants a claim for payment. Non-monetary obligations such as a duty to grant inspection of records (Article 2.3.4) are governed by Article 7.2.2 PICC (Performance of non-monetary obligation).

4. Right to damages (Article 3.1 paragraph (1)(b))

- C14. The right to damages provided by Article 3.1 paragraph (1)(b) is generally governed by Chapter 7 Section 4 PICC.
- C15. Article 7.4.2 PICC follows the principle of full compensation. Courts and arbitral tribunals have no discretion to reduce the amount of damages (cf. Article 7.4.2 PICC Comment 1). Full compensation is subject to the need to prove damages with reasonable certainty as set forth in Article 7.4.3 PICC. Losses recoverable include loss of profits (cf. Article 7.4.2 PICC Comment 2).
- C16. Interest must be paid in case of delay in the payment of a sum of money in accordance with Article 7.4.9 PICC.
- C17. The PICC provide for additional requirements concerning the right to damages which also apply to contracts governed by the PRICL. These include inter alia the requirement of a causal link between the breach and the harm incurred (Article 7.4.2(1) PICC) as well as the foreseeability of the harm at the time of contract formation (Article 7.4.4 PICC).

5. Right to terminate the contract (Article 3.1 paragraph (2))

- C18. The contract may only be terminated where the breach is such that the other party cannot reasonably be expected to uphold the contract. Thus, termination under Article 3.1 paragraph (2) requires that the breach is fundamental. Particular regard shall be given to whether the breach goes “to the root of the contract” or substantially deprives the aggrieved party of the benefit under the contract (cf. *Yam Seng Pte Ltd. v International Trade Corp. Ltd.* [2013] 1 CLC 662, para. 87). These and further important factors are set forth in a non-exhaustive list in Article 7.3.1(2)(a)–(e) PICC which reads: “[...] regard shall be had, in particular, to whether

(a) the non-performance substantially deprives the aggrieved party of what it was entitled to expect under the contract unless the other party did not foresee and could not reasonably have foreseen such result;

(b) strict compliance with the obligation which has not been performed is of essence under the contract;

(c) the non-performance is intentional or reckless;

(d) the non-performance gives the aggrieved party reason to believe that it cannot rely on the other party’s future performance;

(e) the non-performing party will suffer disproportionate loss as a result of the preparation or performance if the contract is terminated.”

- C19. In determining whether the aggrieved party can reasonably be expected to uphold the contract, both an objective and a subjective standard need to be applied. These standards are met when neither a reasonable person in the position of the aggrieved party (objective standard) nor the aggrieved party itself (subjective standard) would uphold the contract. This two-fold approach ensures that farfetched deliberations are not considered sufficient to satisfy the requirement.
- C20. If the requirements of Article 3.1 paragraph (2) are met, the aggrieved party is entitled to terminate the contract, even in case of force majeure (cf. Article 7.1.7 PICC Comment 2).
- C21. Neither the PRICL nor the PICC equate delay in performance alone with fundamental breach. However, Article 7.3.1(3) PICC additionally entitles the aggrieved party to terminate in case of mere delay in performance provided that an additional period of time as provided by Article 7.1.5 PICC had expired. This possibility to set an additional period of time for performance also applies to contracts governed by the PRICL. However, failure to cure the breach within the additional period of time provided does not necessarily establish a right to terminate the contract. Rather, such failure will be considered an additional factor in determining whether a breach is fundamental as described by Article 3.1 paragraph (2).
- C22. Avoidance in case of breach of the pre-contractual disclosure duty is not subject to Article 3.1 paragraph (2) but is specifically regulated by Article 3.2 paragraph (3). However, Article 3.1 paragraph (2) may be applied by analogy to a breach of other pre-contractual duties provided that the aggrieved party cannot reasonably be expected to uphold the contract and could not have been aware of the breach when entering into the contract.
- C23. Article 3.1 paragraph (2) governs only the termination of the breached contract. However, there may be extraordinary cases where breach of one contract creates a situation where the aggrieved party cannot reasonably be expected to uphold other affected contracts because it can no longer trust the other party. In such cases, application of Article 3.1 paragraph (2) by analogy may be considered by the court or arbitral tribunal. However, this may be done only in severe cases in which the fundamental breach permeates the entire relationship between the parties and affects other contracts among the parties. This will not be the case where a breach of contract only deprives the aggrieved party of what it was entitled to expect under this particular contract (cf. Article 7.3.1(2)(a) PICC). This will also not be the case only because the strict compliance with the breached obligation was of essence under this particular contract (cf. Article 7.3.1(2)(b) PICC). However, where the reinsured defrauds the reinsurer in a systematic manner such as repeatedly falsifying claims or where the reinsurer methodically and unreasonably withholds payment, all affected contracts may be terminated.
- C24. The right to terminate the contract does not foreclose pursuit of other remedies provided by Article 3.1 paragraph (1) such as damages or performance of a duty that arose prior to termination.

- C25. Termination under Article 3.1 paragraph (2) requires notice being given according to Articles 7.3.2 to 7.3.5 PICC. Termination is effective as of the date of the notice. It does not have retroactive effect.

6. Annex 1 (Chapter 7 Section 2 PICC)

Article 7.2.1 PICC (*Performance of monetary obligation*): Where a party who is obliged to pay money does not do so, the other party may require payment.

Article 7.2.2 PICC (*Performance of non-monetary obligation*): Where a party who owes an obligation other than one to pay money does not perform, the other party may require performance, unless (a) performance is impossible in law or in fact; (b) performance or, where relevant, enforcement is unreasonably burdensome or expensive; (c) the party entitled to performance may reasonably obtain performance from another source; (d) performance is of an exclusively personal character; or (e) the party entitled to performance does not require performance within a reasonable time after it has, or ought to have, become aware of the non-performance.

Article 7.2.3 PICC (*Repair and replacement of defective performance*): The right to performance includes in appropriate cases the right to require repair, replacement, or other cure of defective performance. The provisions of Articles 7.2.1 and 7.2.2 apply accordingly.

Article 7.2.4 PICC (*Judicial penalty*): (1) Where the court orders a party to perform, it may also direct that this party pay a penalty if it does not comply with the order. (2) The penalty shall be paid to the aggrieved party unless mandatory provisions of the law of the forum provide otherwise. Payment of the penalty to the aggrieved party does not exclude any claim for damages.

Article 7.2.5 PICC (*Change of remedy*): (1) An aggrieved party who has required performance of a non-monetary obligation and who has not received performance within a period fixed or otherwise within a reasonable period of time may invoke any other remedy. (2) Where the decision of a court for performance of a non-monetary obligation cannot be enforced, the aggrieved party may invoke any other remedy.

7. Annex 2 (Chapter 7 Section 4 PICC)

Article 7.4.1 PICC (*Right to damages*): Any non-performance gives the aggrieved party a right to damages either exclusively or in conjunction with any other remedies except where the non-performance is excused under these Principles.

Article 7.4.2 PICC (*Full compensation*): (1) The aggrieved party is entitled to full compensation for harm sustained as a result of the non-performance. Such harm includes both any loss which it suffered and any gain of which it was deprived, taking into account any gain to the aggrieved party resulting from its avoidance of cost or harm. (2) Such harm may be non-pecuniary and includes, for instance, physical suffering or emotional distress.

Article 7.4.3 PICC (*Certainty of harm*): (1) Compensation is due only for harm, including future harm, that is established with a reasonable degree of certainty. (2) Compensation may be due for the loss of a chance in proportion to the probability of its occurrence. (3) Where the amount of damages cannot be established with a sufficient degree of certainty, the assessment is at the discretion of the court.

Article 7.4.4 PICC (*Foreseeability of harm*): The non-performing party is liable only for harm which it foresaw or could reasonably have foreseen at the time of the conclusion of the contract as being likely to result from its nonperformance.

Article 7.4.5 PICC (*Proof of harm in case of replacement transaction*): Where the aggrieved party has terminated the contract and has made a replacement transaction within a reasonable time and in a reasonable manner it may recover the difference between the contract price and the price of the replacement transaction as well as damages for any further harm.

Article 7.4.6 PICC (*Proof of harm by current price*): (1) Where the aggrieved party has terminated the contract and has not made a replacement transaction but there is a current price for the performance contracted for, it may recover the difference between the contract price and the price current at the time the contract is terminated as well as damages for any further harm. (2) Current price is the price generally charged for goods delivered or services rendered in comparable circumstances at the place where the contract should have been performed or, if there is no current price at that place, the current price at such other place that appears reasonable to take as a reference.

Article 7.4.7 PICC (*Harm due in part to aggrieved party*): Where the harm is due in part to an act or omission of the aggrieved party or to another event for which that party bears the risk, the amount of damages shall be reduced to the extent that these factors have contributed to the harm, having regard to the conduct of each of the parties.

Article 7.4.8 PICC (*Mitigation of harm*): (1) The non-performing party is not liable for harm suffered by the aggrieved party to the extent that the harm could have been reduced by the latter party's taking reasonable steps. (2) The aggrieved party is entitled to recover any expenses reasonably incurred in attempting to reduce the harm.

Article 7.4.9 PICC (*Interest for failure to pay money*): (1) If a party does not pay a sum of money when it falls due the aggrieved party is entitled to interest upon that sum from the time when payment is due to the time of payment whether or not the non-payment is excused. (2) The rate of interest shall be the average bank short-term lending rate to prime borrowers prevailing for the currency of payment at the place for payment, or where no such rate exists at that place, then the same rate in the State of the currency of payment. In the absence of such a rate at either place the rate of interest shall be the appropriate rate fixed by the law of the State of the currency of payment. (3) The aggrieved party is entitled to additional damages if the non-payment caused it a greater harm.

Article 7.4.10 PICC (*Interest on damages*): Unless otherwise agreed, interest on damages for non-performance of non-monetary obligations accrues as from the time of nonperformance.

Article 7.4.11 PICC (*Manner of monetary redress*): (1) Damages are to be paid in a lump sum. However, they may be payable in instalments where the nature of the harm makes this appropriate. (2) Damages to be paid in instalments may be indexed.

Article 7.4.12 PICC (*Currency in which to assess damages*): Damages are to be assessed either in the currency in which the monetary obligation was expressed or in the currency in which the harm was suffered, whichever is more appropriate.

Article 7.4.13 PICC (*Agreed payment for non-performance*): (1) Where the contract provides that a party who does not perform is to pay a specified sum to the aggrieved party for such nonperformance, the aggrieved party is entitled to that sum irrespective of its actual harm. (2) However, notwithstanding any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the harm resulting from the non-performance and to the other circumstances.

ARTICLE 3.2

(Remedies for breach of pre-contractual duty of disclosure)

(1) If the prospective reinsured breaches its duty of disclosure as set forth in Article 2.2.1 and if the reinsurer, had it known the undisclosed information, would have entered into the contract on different terms and conditions other than the premium, the reinsurer is entitled to retroactively adjust the contract to these different terms and conditions.

(2) Subject to paragraph (1), if the prospective reinsured breaches its duty of disclosure as set forth in Article 2.2.1 and if the reinsurer, had it known the undisclosed information, would have entered into the contract on a higher premium, the reinsurer is entitled to

(a) proportionally reduce the amount to be paid on any claim arising from a loss that occurred before the reinsurer became aware of the breach and

(b) claim the higher premium for the remaining contract period while providing full coverage according to the adjusted contract for all claims arising from a loss that occurred after the reinsurer became aware of the breach.

If the reinsured notifies the reinsurer, within reasonable time after the adjustment, it is entitled to pay the higher premium retroactively to the formation of the contract and to full coverage for losses of which it was not aware prior to notification.

(3) A breach of the duty of disclosure as set forth in Article 2.2.1 by the prospective reinsured entitles the reinsurer to avoid the contract retroactively if

(a) the duty was breached fraudulently, or

(b) the reinsurer would not have entered into the contract at all had it known the undisclosed information.

(4) If the reinsurer exercises a remedy pursuant to paragraphs (1) to (3), it may claim additional damages.

COMMENTS

1. Relation to the PICC

- C1. Article 3.2 states the exclusive remedies for breach of the duty of pre-contractual disclosure. As a consequence, if a reinsured breaches this duty, the reinsurer is not entitled to avoid the contract for mistake pursuant to Article 3.2.2 PICC or for fraud pursuant to Article 3.2.5 PICC.
- C2. Damages pursuant to an application by analogy of Chapter 7 Section 4 PICC (cf. Article 7.4.1 PICC Comment 3) may only be claimed in accordance with Article 3.2. Thus, the reinsurer does not have a choice between claiming damages and adjusting or avoiding the contract, as the case may be. The reinsurer is bound to exercise the remedies as set forth in Article 3.2 paragraph (1)–(3) and may only claim such damages which are not cured by the exercise of these remedies. This will usually be reliance damages (see Comment 37 below).

2. Structure of the provision

- C3. Article 3.2 is designed in a threefold structure. Paragraphs (1) and (2) determine the consequences of a breach of the pre-contractual duty of disclosure in cases where the reinsurer would have entered into the contract albeit on different terms and conditions. In principle, paragraphs (1) and (2) allow for an adjustment whereas paragraph (3) allows for the avoidance of the contract. Paragraph (4) grants additional damages which are not already covered by paragraphs (1) to (3).

3. Determining breach of the duty of disclosure as set forth in Article 2.2.1

- C4. Exercise of the remedies of Article 3.2 requires a breach of the duty of disclosure established in Article 2.2.1. This requirement is met if the prospective reinsured does not provide the reinsurer with all information of which it is or reasonably ought to be aware that is material to the risks to be assumed by the reinsurer. Breach of the duty is determined according to Article 2.2.1 and Comments thereto.

4. Remedies in general

- C5. Article 3.2 stipulates remedies only for breaches of the pre-contractual duty of disclosure. The Article mentions non-disclosure but does not explicitly refer to misrepresentation. However, non-disclosure under the PRICL includes the concept of misrepresentation (cf. Article 2.2.1 Comment 3).
- C6. Breaches of other pre-contractual duties may relate to the duty of utmost good faith (Article 2.1.2) and the duty of confidentiality (Article 2.1.3). Remedies for breach of such duties are provided by the PICC, e.g. Article 2.1.15 PICC (concerning the duty to negotiate in good faith), Article 2.1.16 PICC (concerning the duty of confidentiality) and Article 7.4.1 PICC (concerning the right to damages in general and including damages for breach of pre-contractual duties).

- C7. Article 3.2 is based on the assumption that both parties to the contract have an interest in upholding it regardless of the breach. Therefore, the PRICL take the approach to uphold the contract. Accordingly, adjustment is the favored remedy and avoidance is the remedy of last resort available only where strict requirements are met (paragraph (3)).
- C8. Article 3.2 seeks to provide the reinsurer with remedies which are proportionate to the gravity of the breach and its consequences. The Article balances the interests of the parties and also reflects modern developments in insurance and reinsurance, e.g. in Chapter 4 Schedule 1 *UK Insurance Act 2015*.
- C9. The reinsurer may unilaterally exercise the remedies granted, in particular the adjustment of the contract; the reinsurer bears the burden of proof for the availability of the remedies.
- C10. In accordance with the principle of good faith as provided in Article 1.7 PICC and the principle of utmost good faith as provided in Article 2.1.2, a reinsurer entitled to a remedy under Article 3.2 may be restricted when exercising such right. E.g. a reinsurer may not be able to adjust the contract pursuant to paragraph (1) and (2) or to avoid it pursuant to paragraph (3) if it has not pursued that right within a reasonable time. Generally speaking, the concept of inconsistent behavior (*venire contra factum proprium*; cf. Article 1.8 PICC) applies to the exercise of such remedies. For example, a reinsurer may not exercise a remedy if the breach was caused by its act or omission or if the reinsurer was aware of the undisclosed information. Cf. Article 7.1.2 PICC (Interference by the other party).
- C11. Questions concerning limitation are governed by Chapter 10 PICC. In particular, the maximum limitation period of ten years as provided in Article 10.2(2) PICC applies where the reinsurer remains unaware of the breach. In contrast, the principle of utmost good faith generally requires the reinsurer to exercise its remedy within a reasonable time after becoming aware of the non-disclosure. The reinsurer is then not allowed to rely on the general limitation period of three years pursuant to Article 10.2(1) PICC.

5. Right to adjust the contract

a. Deterrent effect

- C12. Traditionally, reinsurers could avoid the contract for the reinsureds' breach of the pre-contractual disclosure duty and thereby were fully discharged. The harshness of this remedy provided a strong deterrent effect. However, contract avoidance was often a disproportionate remedy.
- C13. Contract adjustment as provided by paragraph (1) and (2) reflects a more proportionate approach. At the same time, the question arises whether adjustment provides sufficient motivation for the reinsured to make full disclosure. The concern is that the adjustment remedy allows the non-disclosing reinsured to be no worse off than it had been had it made proper disclosure.
- C14. This concern is overstated. In cases of fraud or where the reinsurer demonstrates that it would not have entered into the contract at all, the remedy of avoidance remains

available. Furthermore, in cases of adjustment, the reinsured will be worse off in many situations. For example, where the reinsurer adjusts the contract by inserting an exclusion clause, losses which occurred in the past and are subject to the exclusion clause will not be covered at all. Moreover, where the reinsurer has received an inadequate premium relative to the risk, the amount to be paid will be reduced proportionately and lead to the effect that the reinsured is only partially covered. This provides sufficient incentive for the reinsured to adhere to its duty of disclosure.

b. Different terms and conditions other than the premium pursuant to paragraph (1)

- C15. Paragraph (1) establishes a right to retroactively adjust the contract where the reinsurer demonstrates that it would have entered into the contract only on different terms and conditions. As a consequence, such terms and conditions form part of the contract retroactively.
- C16. The formula “terms and conditions” as mentioned in paragraph (1) is used as a synonym for any kind of contract clause. It is used in a broad sense. The wording would even cover the premium arrangement. However, the premium is expressly excluded from the scope of application of paragraph (1) because it is directly addressed in paragraph (2). The differentiation between premium and other terms and conditions is consistent with Chapter 4 Schedule 1 *UK Insurance Act 2015*.
- C17. One of the scenarios addressed by paragraph (1) concerns a situation in which the reinsurer would have excluded a risk had it known the undisclosed information. In such cases, the reinsurer has the option of retroactively inserting such an exclusion into the contract. This exclusion would become part of the contract and may release the reinsurer from providing coverage for a risk initially insured under the contract.

Illustration

11. Reinsured A fails to disclose the information that it insures large asbestos manufacturers. Reinsurer B would never have entered into the contract without and asbestos exclusion. When B is presented with asbestos claims it is entitled to insert an asbestos exclusion retroactively.
- C18. In another scenario, a reinsurer may have been willing to accept the risk but only at a lower limit had it been aware of the undisclosed information. In such cases, the reinsurer would be able to adjust the contract by reducing its liability to the limit it would have covered.

Illustration

12. Reinsured A purchases a USD 500 million coverage from reinsurer B. A fails to disclose the information that a considerable portion of its property policies coverage risks located in Florida, a state where hurricane losses are common. B’s underwriting guidelines provide a maximum cover limit of USD 100 million where the risk involves Florida property. Upon discovering the true facts, B is entitled to limit its cover to USD 100 million in accordance with its underwriting guidelines.

c. Higher premium pursuant to paragraph (2)

- C19. Paragraph (2) addresses remedies of the reinsurer in case it would have entered into the contract on a higher premium had it known the undisclosed information. The reinsurer's rights to adjust the premium (paragraph (2)(a)) and to reduce the amount to be paid on a claim (paragraph (2)(b)) protect its interest in receiving a premium adequate to the risk. At the same time, paragraph (2) upholds the contract which is in both parties' interest.
- C20. The remedy to proportionally reduce the amount to be paid according to paragraph (2)(a) relates to any claim arising from a loss that occurred before the reinsurer became aware of the breach. This applies irrespective of how such loss will be allocated under the allocation clause in the contract. For example, if a loss occurring before the reinsurer became aware of the non-disclosure is allocated to a period following such awareness, the amount to be paid may nevertheless be reduced proportionately. In turn, if a loss occurring after the reinsurer became aware of the non-disclosure is allocated to a period prior to such awareness, the amount to be paid is not reduced. The reinsured may respond to this situation by accepting to pay the higher premium even retroactively (paragraph (2) sentence 2). This is dealt with Comment 22 below.
- C21. In determining the proportionate reduction, the reinsurer must use the ratio of the premium actually charged to the higher premium that would have been charged had the reinsurer been correctly informed.

Illustration

- I3. Reinsured A issues automobile liability policies and states that it has 100,000 policies in force. In fact, it has 200,000 policies in force. A contracts with reinsurer B which charges USD 10 million for the coverage but would have charged USD 20 million had it known the actual facts. B is entitled to reduce the amount to be paid on claims by 50 percent.
- C22. Paragraph (2)(b) grants the reinsurer the right to claim the premium it would have charged had it known the undisclosed information. This higher premium applies to the remaining contract period. Correspondingly, all claims arising from a loss that occurred after the reinsurer became aware of the breach are covered as provided in the contract. This applies irrespective of whether the reinsurer actually adjusts the premium.
- C23. This approach deviates from the solution set out in the *UK Insurance Act 2015*. Paragraph (2)(b) operates prospectively as from the moment the reinsurer becomes aware of the non-disclosure. From that moment on, it puts the parties in the position they would be in had they contracted on the basis of full disclosure. By contrast, the *UK Insurance Act 2015* only provides for a proportionate reduction of the amount to be paid on claims (cf. Chapter 4 Schedule 1 paragraph (6)). Where the breach was deliberate or reckless, the UK Act provides the reinsurer with the additional right to terminate the contract (cf. Chapter 4 Schedule 1 paragraph (8)).
- C24. Paragraph (2) Sentence 2 grants the reinsured the right to pay the higher premium retroactively to the formation of the contract. This right is exercised by notifying the

reinsurer within reasonable time after the premium adjustment. As a consequence, the reinsured is entitled to coverage as provided in the contract but only for losses of which it was not aware prior to notification. The rule in paragraph (2) sentence 2 anticipates situations in which contracts of reinsurance involve long-tail risks.

C25. “Reasonable” refers to the period of time which is necessary for the reinsured to give notice as soon as circumstances permit. The time necessary to give notice for the reinsured will include an appropriate time to assess the situation.

C26. The reinsured’s right to pay the premium retroactively depends on the actions taken by the reinsurer. Where the reinsurer does not exercise the right to adjust the premium, the counter-right of the reinsured will not arise.

6. Right to avoid the contract pursuant to paragraph (3)

a. Avoidance in general

C27. As mentioned before, it is the aim of the PRICL to uphold the contract wherever possible. Therefore, the entitlement of the reinsurer to avoid the contract is restricted to extraordinary cases only. For the same reason, the requirements of the remedy are to be interpreted restrictively.

C28. There are only two alternative situations in which paragraph (3) permits avoidance: either, the reinsured has acted fraudulently or the reinsurer would not have entered into the contract at all had it known the undisclosed information.

C29. Where the contract is avoided according to paragraph (3), the reinsurer is not entitled to retain the premium received. However, parties may have agreed on the reinsurer being entitled to retain the premium or, in order to reach a similar result, on a liquidated damages or penalty clause. Such clauses are subject to a reduction to a reasonable amount pursuant to Article 7.4.13(2) PICC as well as to the general principle of utmost good faith pursuant to Article 2.1.1. Moreover, prohibitions of penalty clauses under national law may be classified by a court or an arbitral tribunal as constituting an internationally mandatory rule which takes precedence over the PRICL pursuant to Article 1.1.5.

Examples of such prohibitions under national law are presented e.g. in *Axa General Insurers Ltd v Gottlieb* [2005] EWCA Civ 112 Lloyd’s Rep IR 369; *Schoeman v Constantia*, 2003 6 SA 313 (SCA); *Pearl Assurance Co v Union Government*, 1934 AD 560 (PC).

C30. Avoidance under paragraph (3) requires notice being given according to Articles 3.2.11 and 3.2.12 PICC. In line with Article 3.2.14 PICC, avoidance affects the validity of the contract retroactively, i.e. back to the point in time when the contract was formed. The legal consequence is that each party may claim restitution of whatever it has supplied under the contract. Restitution is governed by Article 3.2.15 PICC. The reinsurer may not avoid the contract if it impliedly or expressly confirmed the contract pursuant to Article 3.2.9 PICC.

b. Alternative 1: Fraudulent breach pursuant to paragraph (3)(a)

- C31. The first situation in which the reinsurer is entitled to avoid the contract is where the reinsured has fraudulently not disclosed material information. A non-disclosure is fraudulent if it is intended to mislead the reinsurer and to gain an advantage to the reinsurer's detriment. The reinsured will usually intend to gain the advantage of a contract that the reinsurer would either not have entered into at all or that it would have only entered into on different terms and conditions. Avoidance does, however, not require the reinsured to actually gain the intended advantage.

Illustration

- I4. Reinsured A fears that reinsurer B might not enter into the contract if A insures more than 100,000 property units in Florida. In fact, A insures 150,000 units in Florida but tells B that the number was 90,000 units expecting B to enter into the contract on that basis. B is actually willing to contract with an insurer that covers 200,000 units in Florida. While A's fraudulent non-disclosure concerned a material information (the number of units insured in Florida) the non-disclosure did not affect B's decision to enter into the contract. Nevertheless, B has the right to avoid the contract.

c. Alternative 2: Non-disclosure causing formation of the contract pursuant to paragraph (3)(b)

- C32. The second situation in which the reinsurer is entitled to avoid the contract, is where it would not have entered into the contract at all had it known the undisclosed information. This requirement would be met, for example, where a reinsurer categorically refuses to cover the non-disclosed risk.

Illustration

- I5. Reinsurer B's retrocessionaires exclude coverage for pollution risks. Therefore, B never reinsures pollution risks. Reinsured A insures a large amount of pollution risks but negligently does not disclose this to B. A and B enter into a contract. B is entitled to avoid the contract.
- C33. In determining whether the reinsurer would not have entered into the contract at all a subjective standard must be applied. Accordingly, it is required that the specific reinsurer would not have entered into the contract at all. To judge this, the relevant point in time will be the moment of contract formation. In general, internal guidelines of the specific reinsurer can serve as evidence. Mere far-fetched contentions do not serve as credible evidence. The credibility of the evidence may be supported by objective criteria. The reinsurer may, for example, argue that a reasonable person in its position would not have entered into the contract at all.
- C34. There is a difference between the disclosure duty of the prospective reinsured and the reinsurer's remedy of avoidance. The test for the avoidance remedy as set forth in paragraph (3)(b) is subjective whereas the test for materiality as set forth in Article 2.2.1 is objective (see Article 2.2.1 Comments 5 et seqq.). Regarding the duty to disclose, this

is because a prospective reinsured is normally not expected to know the subjective views of the reinsurer whereas it is expected to know the views of a reasonable reinsurer. In contrast, since the remedy of avoidance is aiming at the protection of the specific reinsurer's freedom of contract, it can only be judged on the basis of a subjective standard, what the decision of the specific reinsurer would have been.

C35. Exercise of the remedy avoids the contract in its entirety.

7. Right to claim damages pursuant to paragraph (4)

C36. In spite of an adjustment (paragraphs (1) and (2)) or an avoidance (paragraph (3)) of the contract, the reinsurer may have incurred harm. Paragraph (4) entitles the reinsurer to claim damages for such additional harm. Exercising the remedy of avoidance or adjustment is a prerequisite of the claim for damages pursuant to paragraph (4).

Illustrations

I6. Reinsured A fraudulently breaches its pre-contractual duty of disclosure towards reinsurer B. B may avoid the contract pursuant to paragraph (3)(a). Avoidance should put B in the position it would be in had it not entered into the contract. However, B may have incurred costs when negotiating the contract and these losses cannot be recovered by avoidance. In this case, B is entitled to claim damages in the amount of the negotiation costs.

I7. Reinsurer C adjusts the premium pursuant to paragraph (2)(b). For that purpose it has to re-evaluate the risk which may require the reinsurer to incur costs, e.g. when there is a need to revise an expert opinion which formed the basis of the initial premium calculation. C is entitled to compensation for these additional costs.

C37. All aspects not covered by paragraph (4) are subject to Chapter 7 Section 4 PICC which applies to pre-contractual duties by analogy (see Article 7.4.1 PICC Comment 3). In cases of pre-contractual non-disclosure, full compensation pursuant to Article 7.4.2 PICC will usually result in "reliance damage" being awarded. Interest must be paid in case of delay in the payment of a sum of money in accordance with Article 7.4.9 PICC. Furthermore, the requirement of a causal link between the breach and the harm incurred (Article 7.4.2(1) PICC), the foreseeability of the harm at the time of contract formation (Article 7.4.4 PICC), etc. apply.

CHAPTER 4

Loss allocation

ARTICLE 4.1

(Scope of application)

This Chapter applies where the parties to the contract agree to allocate losses according to a “losses occurring” basis or “risks attaching” basis.

COMMENTS

- C1. This Chapter addresses the allocation basis of a reinsurance contract. Reinsurance is commonly underwritten on a “losses occurring” or “risks attaching” basis (CLYDE & CO 1.109; *Wasa International Insurance Company Limited v Lexington Insurance Company* [2009] UKHL 40, 41 citing *Balfour v Beaumont* [1984] 1 Lloyd’s Rep 272). The PRICL therefore stipulate a default understanding of the notion of “losses occurring” (Article 4.2) and “risks attaching” (Article 4.3). The parties to a contract are nevertheless free to contractually modify, deviate or depart from the default understanding. The terms and conditions of the contract will, as a matter of principle, take precedence over the default rules provided for by the PRICL (see Article 1.1.3).
- C2. This Chapter is also applicable where the exact words “losses occurring” or “risks attaching” are not used, but a common intention of the parties to allocate losses according to a “losses occurring” or “risks attaching” basis – as it is provided for in and understood by the PRICL – is established by means of contract interpretation (for the applicable rules on contract interpretation, see Chapter 4 PICC).
- C3. The parties to a contract governed by the PRICL may also agree on a different, less common and widespread allocation basis (e.g. “accounted for”, “loss discovered”). In this case, it is advisable to describe the mode of operation of such allocation basis comprehensively in the contract, as there is no default understanding provided for it in the PRICL.

ARTICLE 4.2

(Losses occurring)

(5) An allocation clause referring to “losses occurring” brings within the temporal scope of the contract any obligation of the reinsured arising during the reinsurance period as a consequence of the materialization of a peril insured against under the reinsured relationship.

(6) The point in time when the obligation of the reinsured arises is to be determined pursuant to the terms and conditions of the reinsured relationship and the law applicable thereto.

COMMENTS

1. The term “loss”

- C1. The notion of the “losses occurring” allocation basis is explained in Article 4.2. As a part of the term “losses occurring”, the word “loss” refers to the coverage obligation of the reinsured, i.e. to the reinsured’s pecuniary contractual obligation to make payment based on the materialization of a peril insured against under the reinsured relationship (cf. the clause reprinted in SNEED 59, 63). In contrast, in the rules on loss aggregation, the word “loss” is used to denote the monetary damage incurred by the primary insured (cf. Article 5.1 Comment 11). Despite this discrepancy, the PRICL retain the term “losses occurring”, as it has a settled meaning in the reinsurance industry, having been employed by industry participants for a considerable period of time.
- C2. It is immaterial whether the reinsured relationship provides for indemnification against loss or damage suffered by the policyholder or another person (indemnity insurance, cf. Article 1:201(3) PEICL) or for payment of a contractually pre-determined fixed sum on the occurrence of an insured event defined in the policy (insurance of fixed sums, cf. Article 1:201(4) PEICL).

2. Obligations of the reinsured as a consequence of the materialization of a peril insured against

- C3. Article 4.2 only addresses obligations of the reinsured arising as a consequence of the materialization of a peril insured against under a reinsured relationship. The wording shall be construed in a broad way, so as to encompass not only the insurance benefit but all of the reinsured’s pecuniary obligations causally connected to the materialization of a peril insured against under the reinsured relationship (cf. Article 1:201(2) PEICL). For example, costs incurred for obtaining an expert opinion required to settle an insurance claim also arise as a consequence of an insured peril having materialized.
- C4. By contrast, the wording emphasizes the fact that the notion of the concept of “losses occurring” shall not cover a reinsured’s pecuniary obligations vis-à-vis the policyholder which are unrelated to the materialization of an insured peril, irrespective of their legal basis. This would be the case for, *inter alia*, premiums claimed and recovered by a policyholder upon retroactively avoiding the insurance contract. Such payments by the reinsured would admittedly usually not even be covered by the reinsurance contract. In general, it shall be noted that the rules on loss allocation merely play a role in determining the temporal scope of reinsurance coverage, they do not extend reinsurance coverage beyond the terms and conditions agreed by the contracting parties (cf. also Comment 33 below).

3. The emergence of the obligation of the reinsured

- C5. The emergence of the reinsured's coverage obligation as a consequence of the materialization of a peril insured against under the reinsured relationship is the decisive factor for allocation under Article 4.2; said obligation must arise during the reinsurance period in order to be allocated thereto (for the general relevance of the reinsurance period, cf. *Wasa International Insurance Company Limited v Lexington Insurance Company* [2009] UKHL 40, 41). In contrast, the materialization of the peril insured against, which forms the basis of the reinsured's coverage obligation, is not required to take place during the reinsurance period as a matter of principle.
- C6. In order to determine which condition provokes the coverage obligation of the reinsured under the reinsured relationship, the terms and conditions of the reinsured relationship must be considered in their entirety, giving due regard to the contract as a whole. The terms and conditions of the reinsured relationship are to be construed under the law applicable to it. For the relevance and role of the law governing the reinsured relationship, see Comments 16 et seqq. below.
- C7. In some jurisdictions, reference is made to the "trigger of coverage", in particular in the context of liability insurance. The term "trigger of coverage" is "a shorthand expression for identifying the events that must occur during the policy period to require coverage for losses sustained by the policyholder" (*Owens-Illinois, Inc v United Ins Co*, 138 NJ 437, 650 A2d 974, 976 (1994)) or, under another definition "that which, under the specific terms of an insurance policy must happen in the policy period in order for the potential of coverage to arise." (*Montrose Chem Corp v Admiral Ins Co*, 10 Cal 4th 645, 42 Cal Rptr 2d 324, 913 P2d 878, 880 et seq. (1995)). The latter definition is especially helpful in building a link between the terms "trigger" and "insured event". An "insured event" means the occurrence of the uncertain event defined in the insurance contract (cf. Article 1:201 PEICL C5) and has the effect of converting the insurer's obligation to bear the risk assumed into an obligation to make payment (coverage obligation; cf. SCHAUER 145). The term "trigger of coverage" is used to denote the condition that activates an insurer's coverage obligation under a contract (cf. MATHIAS, SHUGRUE AND MARRINSON 9-60; also for example *Hoechst Celanese Corp v Certain Underwriters at Lloyd's of London*, 673 A2d 164, 166, n2 (Del 1996)) and therefore refers to the fact constituting the insured event under a specific contract (cf. Article 14:107 PEICL C2).
- C8. The contracting parties are usually free to define the insured event in the insurance contract. Hence, determining the relevant triggering factor in a particular case primarily depends upon the language of the policy (ANDREA 813, 830; e.g. *Don's Bldg Supply, Inc v OneBeacon Ins Co*, 2008 WL 3991197 (Tex 2008)). However, the applicable law may also play a role (cf. *Energynorth Natural Gas, Inc v Underwriters at Lloyd's*, 150 NH 828, 848 A2d 715 (NH 2004); for the relevance of the governing law, see Comments 16 et seqq. below).
- C9. For example, under a contract of liability insurance, an insurer's coverage obligation may be activated by the insured committing an act or by the occurrence of a fact for which the insured is legally liable that could conceivably have led to the loss or damage (exposure trigger, the first such act among multiple acts or the first such fact among multiple facts is relevant), by the insured committing the initial act ultimately causing

damage or by the occurrence of a fact ultimately causing damage for which the insured is legally liable, by the actual occurrence of loss or damage to a third person (injury-in-fact trigger), by the manifestation of loss or damage to a third person (manifestation trigger), by the making of a claim for damages against the policyholder by a third person (claims made), or by the reporting by the policyholder to the insurer of a claim for damages made against the policyholder by a third person (claims made and reported) (cf. Article 14:107 PEICL; MATHIAS, SHUGRUE AND MARRINSON 9-60 et seqq.; MALPIGLI 283 et seqq.). Some insurance policies refer to a combination of the basic triggering factors (cf. *Joe Harden Builders, Inc v Aetna Casualty and Surety Co*, 486 SE2d 89 (SC 1997)) or adopt multiple triggers (FISCHER 625, 641). With regard to the continuous trigger, see Comments 25 et seqq. below.

- C10. Identical factual circumstances therefore do not require the same allocation where the content of the reinsured relationships in question varies (see also *Energynorth Natural Gas, Inc v Underwriters at Lloyd's*, 150 NH 828, 848 A2d 715 (NH 2004)).

Illustration

- I1. A manufacturer produces a defective oven. After being sold, the oven explodes and injures the buyer when preparing the Christmas dinner on 25 December 2017. The buyer only makes the claim against the manufacturer after returning from hospital on 15 January 2018. The manufacturer has product liability coverage in place; the contract covering the product liability policy is written on a “losses occurring” basis and renewed annually with the renewal date being 1 January.
 - I2. According to the insurance contract, coverage is triggered by the actual occurrence of loss or damage to a third person (injury-in-fact trigger). Thus, the reinsured’s coverage obligation arose on 25 December 2017 – at the point in time when the oven exploded, causing the buyer’s injury. Pursuant to Article 4.2, the coverage obligation of the reinsured will be allocated to the contract covering the calendar and underwriting year 2017.
 - I3. According to the contract, coverage is triggered by the making of a claim for damages by a victim based on the policyholder’s product liability (cf. Article 14:107(2) PEICL). Thus, the reinsured’s coverage obligation arose on 15 January 2018 – at the point in time when the claim was made by the buyer. Pursuant to Article 4.2, the coverage obligation of the reinsured will be allocated to the contract covering the calendar and underwriting year 2018. It is irrelevant that the occurrence of the accident and injury forming the basis of the claim falls outside the reinsurance period (cf. Comment 5 above), because the contract defines the insured event with reference to a claim made by the victim, not to the occurrence of loss or damage to a victim that gives rise to the insured’s product liability.
- C11. Naturally, the amount of premium charged by an insurer will depend on the probability of the emergence of its obligation to make payments under the contract concerned, and thus on the contractual definition of the insured event and of the relevant triggering factor.

Illustration

- I4. Under a credit insurance contract, the policyholder may insure against non-payment, protracted default or insolvency of the debtor (cf. section 3 of the *Allgemeine Versicherungsbedingungen für die R+V-Warenkreditversicherung* [AVB WKV] (version 07/2018); cf. also *BGH IV ZR 135/91* VersR 1993, 223, 225). The premium charged by the insurer for providing coverage against non-payment will be higher than in exchange for merely covering the risk of a debtor's insolvency.
- C12. In the course of a loss settlement, the reinsured interprets the terms and conditions of the reinsured relationship and, on this basis, determines at which point in time the coverage was triggered and the insured event occurred, provoking the reinsured's coverage obligation under the reinsured relationship (as to the relevance of the law governing the reinsured relationship, see Comments 16 et seqq. below). The assessment of the reinsured is subject to the duty of the reinsurer to follow the settlements enshrined in Article 2.4.3. As a consequence, the extent to which the reinsured's determination may be reviewed is considerably limited.

Illustration

- I5. In the context of a loss settlement, the reinsured, an insurer under a liability insurance contract, takes the position that, under the contract of insurance, the policyholder's decision to manufacture and sell products containing asbestos constituted a single occurrence resulting in personal injury and giving rise to insured's liability. The reinsurer may only review the reinsured's assessment on the grounds acknowledged by the duty to follow the settlements (*International Surplus Lines Insurance Co v Underwriters at Lloyd's*, 868 F Supp 917 (SD Ohio 1994)).
- C13. There may be a dispute between the reinsured and its policyholder or a victim as to the proper ascertainment of the condition activating the reinsured's coverage obligation under the reinsured relationship. In case mutual understanding cannot be achieved by way of negotiation or mediation, a court or an arbitral tribunal will ultimately decide on the emergence of the reinsured's coverage obligation on the basis of the content of the reinsured relationship and the law governing it. The reinsurer is obligated to accept and abide by such ruling by virtue of the duty to follow the fortunes enshrined in Article 2.4.3.
- C14. Whereas, in obligatory reinsurance, changes and amendments to the terms and conditions of the reinsured relationship generally bind the reinsurer under the doctrine governing the reinsured's right to business management, in facultative reinsurance, alterations of the terms and conditions of the reinsured relationship agreed between the reinsured and its policyholder affecting the risk, the scope of cover or the premium also require the approval of the reinsurer in order to be effective at the reinsurance level (GERATHEWOHL 470 et seqq.). An agreement between the parties to the reinsured relationship regarding the definition and construction of the insured event or the relevant triggering factor is, however, also irrelevant under an obligatory reinsurance contract to the extent that it seeks to adjourn the coverage obligation of the reinsured

which has in fact already arisen. The reinsured shall namely not be able to provoke the liability of the reinsurer by creating or temporally influencing its own contractual coverage obligation by means of an agreement with the policyholder. Thus, although an alteration of the terms and conditions of the reinsured relationship having an impact on the emergence of the coverage obligation of the reinsured may retain its validity within the reinsured relationship, any relevance to such mutual arrangement between the reinsured and its policyholder is denied under the duty of utmost good faith (Article 2.1.2) at the level of reinsurance once the coverage obligation of the reinsured has in fact arisen. This outcome is in line with the general principle of insurance law that an insurer is not obligated to perform if the insured event was intentionally caused by the policyholder (cf. Article 9:101 PEICL).

- C15. It should be noted that further (conceivable) attachment points are irrelevant for the purpose of loss allocation under the PRICL. These generally include, but are not limited to, the point in time when the policyholder became aware of the loss or damage (although a claim made is relevant under an insurance policy based on claims made, cf. Comment 9 above), the point in time when the reinsured was notified of a claim (unless the reinsured relationship is based on claims made and reported), the point in time when proof of the loss or damage was submitted to the reinsured, the point in time when the loss or damage was quantified, the point in time when the reinsured's pecuniary performance under the reinsured relationship became due, the point in time when the reinsured actually made payment to its policyholder or any third person pursuant to the reinsured relationship or the point in time when the policyholder or any such third person received any such payment. A (conditional and/or partial) prepayment of the insurance benefit prior to the emergence of the reinsured's coverage obligation likewise has no influence on the allocation of said obligation at the reinsurance level.

4. The role of the law governing the reinsured relationship

a. In general

- C16. The terms and conditions of the reinsured relationship are not to be viewed in isolation from the provisions of the law governing it. First, as a matter of principle, the content of the reinsured relationship is to be construed under the applicable law (see Comments 6 et seqq. above). Second, the applicable law may play a role in establishing the insured event and in determining which factor leads to coverage under the reinsured relationship being triggered, provoking the reinsured's obligation to make payment as a consequence of an insured peril having materialized (cf. Comments 18 et seqq. below; on the continuous trigger Comments 25 et seqq. below).

Illustration

- I6. In some jurisdictions, it is recognized that under a liability insurance contract "an occurrence happens when the injurious effects of the occurrence become 'apparent' or 'manifest themselves.'" (cf. *Honeycomb Systems, Inc v Admiral Insurance Company*, 567 F Supp 1400 (D Me 1983) with further references). Thus, under a liability insurance contract referring to an "occurrence", the coverage obligation of the reinsured arises upon manifestation of loss or damage (manifestation trigger).

- C17. It is therefore advisable to either include a choice of law in the reinsured relationship or to otherwise ensure that the law applicable to the reinsured relationship is clearly identifiable (cf. *Wasa International Insurance Company Limited v Lexington Insurance Company* [2009] UKHL 40, 44, 49). Regardless of whether the law governing the particular reinsured relationship can be unambiguously ascertained prior to any dispute about the coverage provided thereunder, reinsurers are generally deemed to be aware of rules of insurance and reinsurance law which are not uncommon from a comparative perspective (cf. *Groupama Navigation et Transports v Catatumbo CA Seguros* [2000] 2 Lloyd's Rep 350, 20). By contrast, provisions of the law governing the reinsured relationship having an impact on the allocation under Article 4.2 with unusual or surprising content – in particular those of mandatory nature – are to be disclosed by the (prospective) reinsured (cf. Article 2.2.1).
- C18. Determining whether a rule of the law applicable to the reinsured relationship supersedes a term of the reinsured relationship depends on whether the rule in question is of a mandatory or non-mandatory nature. The PRICL will recognize the determination of the insured event and of the relevant triggering factor pursuant to the content of the reinsured relationship and the law applicable to it, thus including any mandatory rules of the governing law superseding particular terms and conditions of the reinsured relationship.

Illustration

- I7. Article 142 of the Belgian Insurance Act mandatorily provides for coverage on a “loss occurrence” basis with respect to certain liability insurance contracts.
- C19. The application of different trigger theories by courts of various jurisdictions despite identical policy language (ANDREA 813, 850 (1994)) implies that certain trigger theories are of mandatory nature at least in some countries.
- C20. Alternatively, the law applicable to the reinsured relationship may contain a default rule from which the individual contracts may deviate.

Illustration

- I8. Article 14:107(1) PEICL contains a default rule for general liability insurance contracts, defining as the insured event the fact giving rise to the insured's liability that occurred during the liability period of the insurance contract. However, the parties to an insurance contract for commercial or professional purposes may define the insured event with reference to other criteria, such as a claim made by a victim.
- C21. The law governing the reinsured relationship also provides a framework for interpreting the terms and conditions of the reinsured relationship (e.g. for the US principles of interpretation for comprehensive general liability policies, see ANDREA 813, 821 et seqq.). The content of the reinsured relationship may namely need to be interpreted in order to properly construe the insured event and to determine the triggering factor which activates the reinsured's coverage obligation under the given reinsured relationship (cf.

Energynorth Natural Gas, Inc v Underwriters at Lloyd's, 150 NH 828, 848 A2d 715 (NH 2004)).

- C22. It is conceivable that, after formation of the reinsured relationship, a term agreed upon is declared void for incompatibility with a mandatory rule or principle of the applicable law by a court or an arbitral tribunal. This danger particularly pertains to standard terms incorporated into the reinsured relationship (cf. *BGH IV ZR 135/91* VersR 1993, 223, 225; incompatibility denied in the given case). If a contract term relevant for the determination of the insured event is declared void, it will be replaced by way of contract interpretation or supplementation, or, alternatively, by a non-mandatory default rule of the law applicable to the reinsured relationship, where such rule exists. For the purposes of Article 4.2, the condition provoking the emergence of the reinsured's coverage obligation in a given case shall be identified in accordance with the legal situation effective under the reinsured relationship. Reinsurance allocation is therefore based on the outcome and legal consequences of any decision made by a court or an arbitral tribunal declaring that a relevant term of the reinsured relationship is void or superseded by another rule.
- C23. The reasonableness of reinsured's assessment as to the occurrence of an insured event, the relevant triggering factor and the consequential emergence of the reinsured's coverage obligation in the course of a loss settlement is to be evaluated not only with reference to the terms and conditions of the reinsured relationship, but also to the law governing it (cf. SNEED 59, 65). Mandatory rules of the law applicable to the reinsured relationship delimit the room for the application of the standard of reasonable claims behavior (Article 2.4.3 Comments 15 et seq.).
- C24. The reinsurer must also abide by the changes in the law applicable to the reinsured relationship following the formation of the reinsurance contract (cf. *Wasa International Insurance Company Limited v Lexington Insurance Company* [2009] UKHL 40, 110). Under Article 4.2, the point in time when the coverage obligation of the reinsured arises is to be assessed with regard to the law governing the reinsured relationship (cf. Comments 16 et seq. above). An amendment to the applicable (in particular: mandatory) law may therefore alter reinsurance allocation, even if such change was unpredictable and not considered in the computation of the reinsurance premium. It should be noted that the applicable trigger of coverage has not yet been established in some Federal States of the USA (cf. MATHIAS, SHUGRUE AND MARRINSON 9-73 et seq.).

b. Continuous trigger (triple trigger)

- C25. Through recognition of the mandatory rules of the law applicable to the reinsured relationship that impact the incurrance of the reinsured's coverage obligation under the reinsured relationship, inconsistencies that could potentially arise due to the courts applying the continuous trigger shall be prevented with regard to reinsurance allocation. The problems related to this so-called triple trigger are, however, not solved in their entirety, as these also pertain to the recognition of claims series clauses and their effects.

- C26. Under the continuous trigger, the liability in respect of a loss extends to all insurers on the risk from initial exposure up to final manifestation of the loss (*Keene Corp v Insurance Co of North America*, 667 F2d 1034 (DC Cir 1981); *United States Fidelity & Guaranty Co v Thomas Solvent Co*, 683 F Supp 1139, 1163 (WD Mich 1988); ANDREA 813, 844; MATHIAS, SHUGRUE AND MARRINSON 9-64; MALPIGLI 285). Consequently, insurer's coverage obligation arises under each insurance contract covering at least a part of this time span. As the relevant time span usually stretches over multiple insurance periods, many insurers (and consequently, reinsurers) are impacted (for an overview, see ANDREA 813, 844 et seq.).
- C27. Application of the continuous trigger may be supported by the wording of the reinsured relationship as interpreted under the relevant law (cf. *Alcoa v Aetna Cas & Sur Co* 998 P2d 856 (Wash 2000); cf. Comment 8 above). Nevertheless, if the continuous trigger is adopted by a court without giving regard to the terms and conditions of the reinsured relationship or even despite policy language to the contrary, the court is enforcing a mandatory principle of the applicable insurance law (cf. Comment 19 above). When buying reinsurance coverage for policies governed by a law that mandatorily provides for the continuous trigger, the reinsured expects the reinsurance coverage to be equivalent to the coverage under the reinsured policies. Nevertheless, the fact that the governing law provides for a mandatory continuous trigger shall generally be addressed in the course of pre-contractual disclosure subject to the requirements set out in Article 2.2.1. In this regard, the PRICL adequately balance the legitimate interests and expectations of both parties when entering into a contract of reinsurance (cf. also Comments 32 et seq. below).
- C28. However, application of the continuous trigger does not, by itself, determine the amount of liability arising under an individual contract of insurance covering a part of the relevant time span. The overall loss may be apportioned among the liable insurers; e.g. pro rata to the periods of coverage, with the insured being treated as a self-insurer for the periods when no insurance coverage was in place (*Insurance Co of North America v Forty-Eight Insulations, Inc*, 633 F2d 1212 (6th Cir 1980)). Alternatively, the insurers may be jointly and severally liable for the whole loss ("all sums"; *Keene Corp v Insurance Co of North America*, 667 F2d 1034 (DC Cir 1981)). The latter approach does not mean that the economic consequences of the whole loss will ultimately be borne by one insurer chosen randomly among the liable insurers by the policyholder: the performing insurer may seek contributions from other insurers for the risk during the relevant time span (*Boston Gas Co v Century Indemnity Co*, No 07-1452 (1st Cir 2008)). Under the PRICL, this option transforms into an obligation: a reinsured cannot claim payment under a reinsurance contract without first seeking contributions from other liable insurers (cf. Article 2.4.1(2) PRICL).

5. Reinsurance allocation and back-to-back coverage

- C29. According to the presumption of back-to-back coverage in facultative proportional reinsurance (cf. in detail *Vesta v Butcher* [1989] AC 852, 895; see also *Wasa International Insurance Company Limited v Lexington Insurance Company* [2009] UKHL 40, 60), the scope and nature of reinsurance coverage shall be the same as the coverage afforded under the reinsured relationship (*Groupama Navigation et Transports v Catatumbo CA Seguros* [2000] 2 Lloyd's Rep 350, 17). In conformity with this

principle, terms and conditions of the reinsured relationship incorporated into the reinsurance contract by reference or reproduced at the reinsurance level (cf. CLYDE & Co 16.3 et seq.) shall – subject to the mandatory rules of the law applicable to the reinsurance contract – be accorded the same meaning and effect at the reinsurance level as they have under the reinsured relationship. However, the presumption of back-to-back coverage cannot extend the temporal scope of reinsurance coverage by overriding fundamental terms of the reinsurance contract, such as the period clause (*Wasa International Insurance Company Limited v Lexington Insurance Company* [2009] UKHL 40, 16; CLYDE & Co 16.71; on the period clause as a temporal limit of coverage generally, *Municipal Mutual Insurance Ltd v Sea Insurance Co Ltd* [1998] Lloyd's Rep IR 421, 435 et seq.).

- C30. In respect of reinsurance allocation, Article 4.2 follows a different approach. The PRICL, as the law applicable to the reinsurance contract, do not play a role in establishing the insured event, the trigger of coverage applicable under the reinsured relationship or the point in time when the coverage obligation of the reinsured based on the materialization of the insured peril emerged under the reinsured relationship. All these parameters are to be determined at the underlying level pursuant to the terms and conditions of the reinsured relationship and the law applicable thereto (cf. Comments 6 et seqq., 16 et seqq., 27 above). Article 4.2 recognizes such determination (on the possibility of the reinsurer to review and challenge reinsured's assessment, see Comments 12 and 23 above) by taking as a basis for reinsurance allocation the emergence of the reinsured's coverage obligation under the reinsured relationship. In this way, the reinsured relationship is determinative for reinsurance allocation under the PRICL.
- C31. The approach followed by Article 4.2 thus – for the purpose of reinsurance allocation – eliminates the need to examine to what extent the effect of terms and conditions of the reinsured relationship incorporated directly or by reference into the reinsurance contract can be realized at the reinsurance level (cf. CLYDE & Co 16.53 with further references). The model introduced in Article 4.2 is therefore appropriate for all types of reinsurance contracts.
- C32. In this way, Article 4.2 safeguards the foreseeability of reinsurance allocation and the attainment of coherent results under the reinsured relationship and under the contract of reinsurance, eliminating the risk of undesired disparities. The reinsurer will be aware of the fact that the terms and conditions of the reinsured relationship and the law applicable thereto are relevant for its liability under the contract. The parties to the reinsurance contract shall have particular regard to the approach introduced in Article 4.2 when defining the scope of contract coverage and fixing the limit, retention and reinsurance premium.
- C33. The default rule of reinsurance allocation in Article 4.2 is related to the temporal scope of the reinsurance contract. However, it does not have the effect of altering the temporal scope (e.g. period clause) or the substantive scope (e.g. risks covered) of reinsurance coverage agreed between the parties to the contract. Article 4.2 merely identifies the contract to which the adverse economic consequences of a reinsured's obligation to make payment under a reinsured relationship are to be allocated. Whether the reinsurer will actually be obligated to make payment to the reinsured must be determined under

the respective contract, in particular by reference to the substantive scope of reinsurance coverage (cf. also *Hill v Mercantile and General Reinsurance Co Plc* [1996] 1 WLR 1239, 1251; *Wasa International Insurance Company Limited v Lexington Insurance Company* [2009] UKHL 40, 58 et seq.).

ARTICLE 4.3

(Risks attaching)

An allocation clause referring to “risks attaching” brings within the temporal scope of the contract any obligation of the reinsured arising as a consequence of the materialization of a peril insured against under a reinsured relationship incepting or being renewed during the reinsurance period.

COMMENTS

1. The rule

- C1. If a reinsurance contract refers to “risks attaching”, it responds to obligations of the reinsured arising as a consequence of the materialization of a peril insured against under a reinsured relationship (Article 4.2 Comments 3 et seq.) that is incept or renewed during the reinsurance period (CLYDE & CO 1.109), irrespective of the point in time when coverage was triggered under the reinsured relationship, of the point in time when the insured event occurred or of the point in time when reinsured’s pecuniary contractual obligation to make payment based on the materialization of a peril insured against under the reinsured relationship emerged. In the context of this rule, renewal refers to the inception of renewed coverage, not to the point in time when the parties to a reinsured relationship agreed to renew coverage.
- C2. Reinsurance coverage based on “risks attaching” provides for considerable clarity. The only decisive factor is the inception date of the relevant reinsured relationship. Under a reinsurance contract on a “risks attaching” basis, the reinsurer may be confronted with claims of the reinsured years after the reinsurance period has ended. In order to limit their future exposure, reinsurers may reinsure policies with a definite expiration date only (cf. POHL AND IRANYA 37) or provide for a cutoff date in the contract.

CHAPTER 5

Loss Aggregation

ARTICLE 5.1

(Principle)

(1) With regard to deductibles and limits, the parties may agree in the reinsurance contract to treat two or more separate losses allocated to the same reinsurance period as one single loss.

(2) In particular, they may agree to treat two or more separate losses as one single loss based on an aggregation per event or an aggregation per cause.

COMMENTS

1. General remarks

- C1. This chapter of the PRICL deals with the question of whether a reinsured may or must aggregate two or more separate losses for the purpose of presenting a claim to its reinsurers. Legal certainty in the matter of aggregating losses is of fundamental importance as the structure of the coverage forms a vital element in calculating the premium to be charged.
- C2. Aggregating two or more losses and treating them as a single loss may lead to the aggregated loss exceeding the deductible (retention; excess point; attachment point; priority), thereby triggering the reinsurer's duty to indemnify the reinsured. Depending on the sums involved, an aggregation of losses may also lead to a sum in excess of the reinsurance coverage limit, for which the primary insured will not be able to claim indemnification. Determining whom an aggregation of losses will benefit depends on the structure of the coverage (retention/coverage limit) as well as the structure of the separate losses in a specific case.
- C3. An aggregation of losses may be undertaken on the basis of a particular period of time in the sense that all losses that can be attributed to this period (depending on whether the reinsurer's liability is triggered by the underlying 'risk attaching', the underlying 'losses occurring' or 'claims made' by the primary insured) are to be added together for the purpose of determining whether the deductible is exceeded or the cover limit is pierced. So-called aggregate policies do not require that the losses to be aggregated arise from a common unifying factor.
- C4. By contrast, so-called event-based or cause-based policies require that there is some sort of causative link between the individual losses and the respective unifying factor. This Chapter deals exclusively with event-based and cause-based aggregation mechanisms. If the parties agree to aggregate two or more losses based on an aggregating factor other

than either an “event” or a “cause”, the PRICL do not provide any direct insight into where the relevant aggregating factor lies on the chain of causation. In such cases, the PRICL may, however, still provide guidance.

- C5. Generally, the parties are free to agree on whether they want to treat two or more separate losses as a single loss, and if so, under which conditions they wish to do so. If they agree to aggregate separate losses to one single loss, they will generally also agree on a unifying factor of some kind. If a contract does not provide for an aggregation mechanism, no loss aggregation is possible.
- C6. In this Chapter, it will not be possible to dispel all of the uncertainties arising with regard to the aggregation of losses based on an “event” or a “cause”. By making conscious decisions as to what constitutes an “event” or a “cause” under the PRICL, this uncertainty may, however, be reduced considerably. To this end, it is intended that the PRICL provide sensible definitions of the notions of “event” and “cause” in order to make them fit for their purpose in respect of aggregating losses in reinsurance contracts. Hence, it may well be that the meanings the PRICL attach to these notions deviate from the meanings they have in ordinary speech. It should further be noted that the rules set forth in the PRICL do not necessarily coincide with what has been decided by courts around the world.

2. Only individual losses allocated to the same reinsurance period can be aggregated

- C7. Under the PRICL, individual losses will first be allocated to a reinsurance period (see chapter 4). Only individual losses that are allocated to the same reinsurance period may be aggregated in application of Article 5.2 or 5.3. Conversely, if multiple individual losses are allocated to different reinsurance periods they are not to be aggregated even if they arise from the same event or the same cause.

Illustration

- I1. Equipment is stored at a port and vandalized by a succession of individual acts of pilferage during a period of some 18 months. During this time, multiple individual losses occur. The individual losses all result from one originating cause (Article 5.3 paragraph (2)), i.e. the port’s failure to put in place an adequate system to protect the stored goods. Three consecutive contracts of reinsurance are in force during the 18 months period. Contract 1 is in force during the first 3 months, contract 2 during 12 months and contract 3 during the last 3 months.

Article 5.1 paragraph 1 provides that only individual losses that occur when either contract 1, 2 or 3 is in force can be aggregated. By contrast, individual losses that are allocated to different reinsurance periods cannot be aggregated even though they may all originate from the port’s failure of putting in place an adequate system of protecting the stored goods.

- C8. Consequently, the parties cannot extend the reinsurance period by means of an aggregation clause. Rather, if the parties wish to extend the reinsurance period to include losses that result from a cause or event that was initiated during the reinsurance

period but occurred after the latter has elapsed, they may provide for an “extension of protection clause”. Where the contract provides for such a clause, individual losses occurring during the extension of the reinsurance period may be aggregated with losses occurring before the extension.

Illustration

- I2. Reinsurance contract 1 is taken out against the peril of hurricane and is in force from 1 January 2018 to 31 December 2018. Contract 2 is taken out against the same peril and enters into force on 1 January 2019. Both contracts contain an “extension of protection clause” to the effect that if an event develops during the reinsurance period and causes individual losses but is still in progress when the reinsurance expires and thereafter causes further individual losses, the reinsurance period is extended to also cover those latter losses. Moreover, they both contain an event-based aggregation clause.

On 31 December 2018 a hurricane develops and causes multiple individual losses that day. The hurricane continues to swipe over town until the morning hours of 1 January 2019. Accordingly, some of the losses occur on 1 January 2019. Based upon contract 1’s “extension of protection clause” hurricane losses that occur on 1 January 2019 are covered under contract 1. As all individual losses—no matter whether they occurred on 31 December 2018 or 1 January 2019—are allocated to contract 1, they are to be aggregated under Article 5.2 paragraph (1).

3. Deductible, retention, priority, excess point, attachment point

- C9. Both in facultative excess of loss reinsurance and treaty excess of loss reinsurance, a reinsured takes out reinsurance only on a sum in excess of a particular figure. Hence, the reinsured retains liability for the entire loss below that excess point but transfers liability for the part of the loss above that point. The amount of the loss for which liability is retained by the reinsured is termed “deductible”, “retention” or “priority”. The upper limit of a deductible or retention is referred to as an “excess point” or “attachment point”. Excess or attachment points are regularly defined in relation to any losses that arise from a unifying factor, such as an event or a cause. In other words, the reinsurer promises to indemnify the reinsured against any losses arising from a particular event or cause above the excess or attachment point.

4. Cover, limit, cover limit

- C10. Contracts regularly contain limits on liability. More specifically, reinsurers only reinsure their reinsureds up to a certain sum, the so-called “coverage limit”, preventing the reinsureds from claiming indemnification for any loss amount above this “limit”. The parties to a contract regularly define their coverage limit in relation to any losses that arise from a unifying factor, such as an event or cause. In other words, the reinsurer promises to indemnify the reinsured against any losses arising from a particular event or cause up to a fixed amount of money.

5. Loss

- C11. In the context of loss aggregation, the word “loss” generally refers to the monetary damage suffered by the primary insured. By contrast, in the context of loss allocation, the word “loss” refers to the reinsured’s obligation to reimburse the reinsurer under the contract of reinsurance (see Article 4.2 Comment 1).
- C12. With regard to life insurance policies, the word “loss” refers to the primary insured’s death and not to a monetary detriment caused by his death.
- C13. Hence, the notion of “loss” does not refer to the event or “occurrence out of which a claim arises, for loss suffered by the original insured, such as storm damage, flood damage or the like, or in the case of professional [liability] losses, the negligent act or omission of the insured” (cf. *Caudle v Sharp* [1995] CLC 642, 648).

6. Unifying factor

- C14. Individual losses may be aggregated if they all result from one common unifying factor. The terminology used to describe this unifying factor is manifold. In fact, the industry has used the notions of “event”, “occurrence”, “happening”, “accident”, “catastrophe”, “disaster”, “calamity”, “cause” or “source”, etc. to define it.
- C15. In Articles 5.2 and 5.3, there are rules for aggregation either on the basis of an “event” or a “cause”. These two concepts are distinguished by different causation requirements between the individual losses on the one hand and the respective unifying factors on the other hand (cf. Article 5.1 Comments C18 et seqq.).

7. Causation

a. General aspects

- C16. Ordinarily, the parties agree to aggregate losses that have a “common origin in some act or event or cause” (cf. EDELMAN AND BURNS 4.54). Hence, there must be a causal link between the unifying factor on the one hand and all the losses to be aggregated on the other.
- C17. The degree of causality required in relation to loss aggregation is most controversial. As the workings of causation are infinite, the parties must decide how far back on the chain of causation a unifying factor may lie so that it is still justified to aggregate any losses that arise from it.
- C18. Traditionally, contracting parties have used “event-based” and “cause-based” aggregation language. The parties agree on an event-based aggregation if they agree e.g. to aggregate “each and every loss [...] arising out of one event” (*Caudle v Sharp* [1995] CLC 642, 644). They agree on a cause-based aggregation if they agree e.g. to aggregate losses “arising from one originating cause” (*Cox v Bankside Members Agency Ltd* [1995] CLC 671, 679).
- C19. As to the difference between event- and cause-based aggregation, it has been held that an event is something which happened at a particular time, at a particular place, in a particular way. A cause is something less constricted and has a much wider connotation

than the notion of event (*Axa Reinsurance (U.K.) Plc v Field* [1996] 1 WLR 1026, 1035).

- C20. Consequently, cause-based aggregation allows the parties “to look further back” in the chain of causation and to “use a remoter common” unifying factor for determining the aggregate loss than event-based aggregation (LOUW AND TOMPKINSON 11). The question is, however, where exactly on the chain of causation each unifying factor comes to lie.

b. Causation: Unities test is inappropriate

- C21. Applying English law, arbitral tribunals and courts determine the required degree of causation between the relevant event and the separate losses by means of the so-called “unities test”, which was developed in the Dawson’s Field Arbitration. The test assesses whether multiple losses “involve such a degree of unity as to justify their being described as, or as arising out of one” event. “In assessing the degree of unity regard may be had to such factors as cause, locality and time and the intentions of the human agents” (*Kuwait Airways Corporation v Kuwait Insurance Co SAK* [1996] 1 Lloyd’s Rep 664).
- C22. It is undisputed that there must be a causal link between the relevant event and the separate losses (unity of cause). This aspect does not, however, deal with the required strength of these causal links; it only establishes that there must be causal links. It is on the basis of the further aspects of “unity of locality”, “unity of time” and “unity of intentions” that the unities test is meant to assess the strength of the causal links. However, the fact that separate losses occur in close spatial proximity (unity of location), in close temporal proximity (unity of time) and may be the product of related human intentions (unity of intentions) has no bearing on the required level of causation but rather on the level of correlation. Therefore, the unities test can be considered a mixed test of causation and correlation.
- C23. It is certainly possible to test whether separate losses may be aggregated on the basis of a mixed test of causation and correlation. However, testing the unity of location and the unity of time is only sensible if the meaning of proximity in space and time is defined from the outset. The lack of a clear understanding of what spatial and temporal proximity means can be seen as the gravest deficiency of the unities test, as it allows for result-oriented judgments.

Illustration

- I3. In *Aioi Nissay Dowa Insurance Company Ltd v Heraldglen Ltd* [2013] EWHC 154, N 23, the court affirmed the arbitral tribunal’s findings that the New York Twin Towers were located in close proximity to one another but that this proximity “did not give rise to a sufficient degree of unity for them to conclude that” the losses that occurred to them 16 minutes apart from one another can be said to have arisen out of one event. Similarly, the court affirmed that although “there were similarities in the timing of the events from the commencement of the flights to contact with the Towers [...] these were not such as to lead to the conclusion” that the losses can be said to have arisen out of one event. Further,

the court confirmed the tribunals finding that, although the attacks on the Twin Towers could be said to be the “execution of a dastardly plot to turn each [aircraft] into a guided missile”, there was no basis “for concluding that there was any factor amounting to an event of sufficient causative relevance to override the conclusion that two separate hijackings caused separate loss and damage (*Aioi Nissay Dowa Insurance Company Ltd v Heraldglen Ltd* [2013] EWHC 154, N 21).

- I4. In the Dawson’s Field Arbitration, by contrast, three aircraft were hijacked and flown to a remote desert airstrip in Jordan. Thereafter, all three aircraft were blown up one after another “in close proximity more or less simultaneously, within the time span of a few minutes, and as a result of a single decision to do so without any one being able to approach the aircraft between the first explosion and their destruction.” All the losses that resulted from the destruction of the three aircraft were held to have arisen out of one event (*Dawson’s Field Arbitration*, quoted in: *Aioi Nissay Dowa Insurance Company Ltd v Heraldglen Ltd* [2013] EWHC 154, N 9).
- C24. The two Illustrations above demonstrate that the result of the unities test very much depends on how it is conducted. In fact, in the case of the attacks on the Twin Towers, the time span deemed relevant was “the whole period from check-in and passenger scrutiny (i.e. even before the hijacking of the aircraft) to the collapse of each Tower and not just from the time each flight took off” (*Aioi Nissay Dowa Insurance Company Ltd v Heraldglen Ltd* [2013] EWHC 154, N 22) whereas in Dawson’s Field Arbitration the relevant period was considered the time between the blowing up of the first and the blowing up of the third aircraft and not the whole period from the hijacking of the individual aircraft to their destruction.
 - C25. For the purposes of the PRICL, the unities test is, therefore, considered inappropriate for determining whether a plurality of losses can be aggregated.
- c. Causation: Unfortunate event test is inappropriate**
- C26. Applying New York law, courts use the so-called “unfortunate event test” to determine whether a multiplicity of losses arose out of one single or multiple events. The application of the unfortunate event test is, however, limited to third party liability insurance cases (cf. *World Trade Center Properties, L.L.C. v Hartford Fire Insurance Company*, 345 F.3d 154, 190 (2003)).
 - C27. The unfortunate event test determines whether multiple losses result from one event of an unfortunate character that takes place without one’s foresight or expectation. The question at the core of the test is whether the liability arises out of one single or multiple “incidents”. If liability arises out of multiple incidents, they may still be considered one event if they occur in temporal and spatial proximity and are part of the same causal continuum.
 - C28. There is no hard and fast rule determining a particular number of seconds or minutes that must elapse before two incidents are distinct events. Instead, it is relevant whether the relative timing of the various incidents played a role in causing any of the other

incidents. Equally, spatial proximity appears to be relative. Furthermore, to be part of the same event, the operative incidents must be part of the same causal chain. Once an incident occurs and that incident does not, in turn, cause one or more of the other incidents, the causal chain is broken.

- C29. Unlike the unities test, the unfortunate event test not only requires that the different losses arise out of the same event but additionally that one liability triggering incident leads to the other liability triggering incident.

Illustrations

- I5. Reinsured A provides primary automobile liability insurance to primary insured B. B collides with a car in one incident “but an instant” before striking another car in a second incident. The second incident was a consequence of the first incident.

Applying the unfortunate event test, the two collisions are to be considered one sole event as there was temporal and spatial proximity between the two incidents. Further, as one incident was consequential for the other one, the two incidents were part of the same causal continuum (cf. *Hartford Accident & Indemnity company v Edward Wesolowski*, 33 NY2d 169, 907, 910 (1973)).

- I6. Reinsured C provides construction insurance to building company D. D constructs two independent walls situated blocks away from each other on different job sites. “[D]uring heavy rainfall, [one] protecting wall collapsed under the water pressure and destruction poured into a building. Almost an hour later, [the other] wall gave way and water flooded another building.” The collapse of the first wall did not cause the failure of the second. Further, the rainfall in itself did not harm the walls. Rather, the walls collapsed primarily because they were wrongfully built (cf. *Arthur A Johnson Corp v Indemnity Ins Co of N Am*, 7 NY2d, 227 et seq.).

Applying the unfortunate event test, the two collapses are to be considered two events as the collapse of the first wall did not cause the collapse of the second one and the collapses occurred at different locations and different times.

- C30. The connection between the criteria of temporal and spatial proximity as well as the criterion of causal continuum has not been clearly established. Therefore, it is not easy to predict the impact of the different criteria in a specific case. It has been said that courts have reached inconsistent results even when applying the test to similar fact patterns (Murray, The law of describing accidents: a new proposal for determining the number of occurrences in insurance, 118 Yale LJ 1484, 1502).

- C31. For the purposes of the PRICL, the unfortunate event test is, therefore, considered inappropriate for determining whether a plurality of losses can be aggregated.

d. Causation: Proximate cause test is inappropriate

- C32. Particularly under Californian law, courts determine the degree of causation between the unifying factor and the separate losses by means of the so-called “proximate cause test”. This test should not be confused with cause-based aggregation under Article 5.3 or cause-based aggregation under English law.
- C33. The proximate cause test’s principle rationale is that any losses resulting from one proximate, uninterrupted and continuing cause may be considered having arisen from one single event. In law, an act or omission is the proximate cause of a loss if, in a natural sequence, unbroken by any new efficient cause, it produces that loss, and if without it the loss would not have happened. If, on the other hand, a cause is interrupted and replaced by another intervening cause, then the chain of causation is broken, resulting in two or more events depending on the number of intervening causes. An assessment of whether there is proximate cause is based on reasonability.
- C34. The proximate cause test is similar but not identical to the approach taken under the PRICL. The similarity lies in the fact that, under both tests, the unifying factor must be a “direct” cause of the separate losses in order to aggregate them. The difference is that under Article 5.2 the unifying factor must be an “event” rather than any “cause”. The concept of “event” is a narrower one than the concept of “cause” (see Article 5.3 Comments C2 et seq.).
- C35. For the purposes of the PRICL, the proximate cause test is, therefore, considered insufficient for determining whether a plurality of losses can be aggregated.

8. No presumption of back-to-back aggregation mechanisms

- C36. There is no presumption that aggregation clauses in reinsurance contracts are to be interpreted in compliance with the primary insurance policies’ aggregation clauses. In fact, aggregation clauses in non-proportional reinsurance contracts merit an autonomous interpretation under the PRICL.

Illustration

- I7. The aggregation clause in the underlying errors and omissions insurance contract reads: “any one occurrence or series of occurrences arising from one originating cause”. Hence, the primary insurance contract provides for a cause-based aggregation mechanism (cf. *Cox and Ors v Bankside Members Agency Ltd and Ors* [1995] CLC 671, 679).

The primary insurer has taken out non-proportional reinsurance in the matter. The relevant contract provides for the following aggregation clause: “For the purpose of this reinsurance the term ‘each and every loss’ shall be understood to mean each and every loss [...] arising out of one event”. By contrast to the primary insurance contract, the reinsurance contract provides for an event-based aggregation mechanism (cf. *Axa Reinsurance (UK) Plc v Field* [1996] 1 WLR 1026, 1031 f).

The two contracts' aggregation clauses cannot be said to be back-to-back and thus merit autonomous interpretation (cf. *Axa Reinsurance (UK) Plc v Field* [1996] 1 WLR 1026, 1033 f).

ARTICLE 5.2

(Event-based Aggregation)

(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.

(2) Where the parties agree on an event-based aggregation in a contract reinsuring third-party liability insurance policies, all losses that occur as a direct consequence of the same act, omission or fact giving rise or allegedly giving rise to the primary insured's liability shall be considered as arising out of one event.

COMMENT

1. Event, occurrence, catastrophe, disaster, calamity, accident (paragraphs (1) and (2))

C1. In the PRICL, the notions of “occurrence”, “catastrophe”, “disaster”, “calamity” and “accident” are equated with the notion of “event” (cf. *Boston Old Colony Inc v Boston Old Colony Insurance Co*, 85 AD2d 21 (1982), 22). For example, whenever a contract refers to the unifying factor of “catastrophe”, which is often the case in Cat XL reinsurance, the parties agree on an aggregation pursuant to Article 5.2 paragraph (1). Thus, a natural catastrophe, such as a hurricane, may be considered an event for the purpose of Article 5.2 paragraph (1).

2. Individual losses

C2. Article 5.2 paragraph(1) applies where first-party insurance policies are reinsured. In the context of aggregation of losses, the relevant individual losses to be aggregated are suffered by the primary insured and not by the reinsured for compensating the primary insured.

C3. Article 5.2 paragraph (2) applies where third-party insurance policies are reinsured. In the context of aggregation of losses, the relevant individual losses to be aggregated are suffered by the primary insured each time his liability towards a third party is triggered and not by the reinsured for compensating the primary insured.

3. Causation

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).

a. Event – Determination of an instance of materialized peril (paragraph (1))

- C6. In determining the relevant event in cases where first-party insurance policies are reinsured, regard must be had to the purpose and the scope of the reinsurance coverage and in particular the perils reinsured against. Under the PRICL, an event is considered to be an instance of materialized peril reinsured against.
- C7. 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 (cf. Glossary of Insurance and Risk Management Terms, International Risk Management Institute Inc under the search term “risk”, <https://www.irmi.com/term/insurance-definitions/risk>, accessed 7 January 2019).
- C8. 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.
- C9. 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 materialized.
- C10. By contrast, in most cases, scientific data will not be available to determine the number of instances a man-made peril has materialized. Whether a man-made peril has materialized in one or multiple separate instances must be determined from the perspective of reasonable parties at the time the scope of coverage – i.e. the perils reinsured against – was negotiated (cf. *Dawson’s Field Arbitration*, quoted in Clyde & Co, *Reinsurance Practice and the Law*, 2009, no 28.19; *Kuwait Airways Corporation v Kuwait Insurance Co SAK* [1996] 1 Lloyd’s Rep 664, 686).

Illustration

- II. Reinsured A takes out reinsurance for a first-party property insurance policy against the peril of windstorm. Two separate named windstorms cause damage to different buildings. Thus, the peril reinsured against materializes in two separate instances, which therefore constitute two separate events.
- C11. Reinsured B takes out reinsurance for a first-party property insurance policy against the peril of snowstorm. Heavy snowfall occurs and causes a “substantial snow accumulation” on the house’s roof. Due to the weight of the ice and snow, a part of the roof collapses on 1 March. On 17 March, another section of the same roof collapses. The snowstorm can be considered the relevant event. Thus, the peril materializes in one

sole instance (cf. *Newmont Mines Ltd v Hanover Insurance Co*, 748 F2d 127 (2d Cir 1986), in which it was held that the two collapses constituted two different occurrences).

- C12. Reinsured C takes out aircraft hull reinsurance for a fleet of 22 aircraft against the peril of war. Iraq invades Kuwait and hijacks 15 of the 22 aircraft and flies them to Iraq. In the course of the actions that follow the invasion, some of the aircraft are destroyed. As Iraq's invasion of Kuwait can be considered an act of war, it marks the relevant event (for the facts of the case, cf. CLYDE & CO 28.23).
- C13. Reinsured D takes out reinsurance for an aviation hull insurance against the peril of hijacking an airplane. On 11 September 2001, two airplanes are hijacked at different airports and flown into the New York Twin Towers. Thus, the peril insured against (hijacking) materializes in two separate instances. Each hijacking marks a separate event.
- C14. Reinsured E takes out reinsurance for property damage, including insurance against the peril of "an act for terrorist purposes". On 11 September 2001, two airplanes are hijacked at different airports and flown into the New York Twin Towers. The hijackers did so "in execution of a dastardly plot to turn [each aircraft] into a guided missile each directed at one of the two signature Towers of a single property complex". From the perspective of reasonable parties at the time the scope of the reinsurance coverage – i.e. the peril of an act for terrorist purposes – was negotiated, it appears reasonable to consider the terror attack as one single instance. Consequently, one single event occurs (cf. *Aioi Nissay Dowa Insurance Company Ltd v Heraldglenn Ltd* [2013] EWHC 154, N 21 in which a different conclusion was reached).
- C15. If a contract provides for all-risk coverage, the materialization of any unnamed peril that triggers the contract is to be considered a relevant event for the purpose of aggregating losses under Article 5.2 paragraph (1). Similarly, in case a contract covers both named and unnamed perils, the materialization of any unnamed peril may constitute the relevant event within the meaning of Article 5.2 paragraph (1). In such cases, any losses that directly result from the event furthest on the chain of causation may be aggregated under Article 5.2 paragraph (1).

Illustration

- I8. Reinsured F 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 Article 5.2 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.

b. Event – Act, omission or fact triggering liability (paragraph (2))

- C16. Where third-party insurance policies are reinsured, the act, omission or fact for which the primary insured is held liable is deemed the relevant event for the purpose of the aggregation of losses under the PRICL.

Illustrations

- I9. Reinsured A provides professional liability insurance to a managing agent of a syndicate at Lloyd's. This managing agent underwrote 32 insurance contracts. After having discovered that the agent had negligently underwritten these contracts, members of the syndicate brought action in negligence against the managing agent. The Reinsured had indemnified the managing agent for the losses he incurred due to his legal liability towards the members of the syndicate. Thereafter, Reinsured A sought to recover claims it had met under the original indemnity insurance from the reinsurer.

Only the underwriting of each contract in negligence triggered the managing agent's liability. Thus, each instance of underwriting constitutes a separate event (cf. *Caudle v Sharp* [1995] CLC 642, 642; *Axa Reinsurance (UK) Plc v Field* [1996] 1 WLR 1026, 103).

- I10. Reinsured B provides liability insurance to a port. Equipment stored at the port was "vandalised by a succession of individual acts of pilferage." The owner of the equipment brought action against the port for not putting in place an "adequate system to protect the goods from pilferage and vandalism".

The port's failure to put in place an adequate system of protection from pilferage and vandalism did not itself trigger its liability. Rather, the port's liability was triggered with each act of vandalism it was unable to avert. Therefore, each failure to adequately avert an act of vandalism constitutes a separate event under the PRICL (cf. *Municipal Mutual Insurance Ltd v Sea Insurance Co Ltd* [1998] CLC 957, 966 et seqq.).

- I11. Reinsured C provides professional liability insurance to a wholesaler of birdseed. The latter bought birdseed from his manufacturer. One batch of birdseed was contaminated. The wholesaler sold portions of it to eight different customers, each of whom lost their birds.

The wholesaler did not contaminate the birdseed so the contamination cannot be said to have triggered his liability. Rather, the sale of the contaminated goods to his customers triggered his liability. Therefore, each of the eight sales can be considered a separate event under the PRICL (cf. *Maurice Pincoff Co v St. Paul Fire and Marine Insurance Co*, 447 F.2d 204 (1971)).

- I12. Reinsured D provides professional liability insurance to "a chemical manufacturer that has operated in locations throughout the United States since the early 1900s." In the 1980s, federal, state and local governments as well as a

number of private parties commenced environmental actions directed at more than 150 of the manufacturer's plant and disposal sites throughout the country.

The manufacturer's "deficient corporate environmental policy" did not itself trigger his liability. Rather, each act of pollution at each different site triggered the manufacturer's liability. Therefore, each act of pollution constitutes a separate event under the PRICL (cf. *Travelers Casualty and Surety v Certain Underwriters at Lloyd's of London*, 96 NY2d 583 (2001) in which it was held that the pollution of over 150 waste sites did not constitute one single event).

- I13. Reinsured E provides professional liability insurance to the producer of many different products that are contaminated with asbestos. These products were sold to a variety of supermarkets. The supermarkets then sold the products to consumers.

The producer's liability was not triggered by his decision to produce or his manufacturing of asbestos-contaminated products. Rather, his wrongful act consisted in the selling of his products and thereby potentially exposing people to it. Therefore, each sale constitutes a separate event for the purpose of aggregating losses under the PRICL. Consequently, if multiple contaminated products are simultaneously sold to a supermarket and these products then cause harm to different people, all such losses are to be aggregated (cf. *Metropolitan Life Insurance Co v Aetna Casualty and Surety Co* [2001] 255 Conn 295, 896, in which each claimant's initial exposure was held to be a separate occurrence; cf. also *In re: Prudential Lines Inc v American Steamship Owners Mutual Protection against Indemnity Association*, 158 F3d 65 in which "each claimant's exposure" was held to be a separate occurrence; cf. also *Appalachian Insurance Co v General Electric Co*, 8 NY3d 162 in which it was held that each individual plaintiff's continuous or repeated exposure to asbestos was to be considered a separate occurrence; cf. also *Stonewall Insurance Co v Asbestos Claims Management Corporation*, 73 F3d 1178 in which each installation of asbestos-containing products was held to be a separate occurrence).

- I14. Reinsured F provides professional liability insurance to primary insured G – an insurance company. Several of G's underwriters mis-sold pensions for which they were held liable. They have been found to have done so due to their "lack of proper training".

The insurance company and their underwriters did not incur liability until they mis-sold pensions to their customers. Hence, each act of mis-selling is to be considered a separate event. By contrast, the underwriters' lack of training did not itself trigger their or their employer's liability and can, thus, not be an event for the purposes of Article 5.2 paragraph (2) (cf. *Countrywide Assured Group Plc v Marshall* [2002] WL 31173646, 6, a primary insurance case which dealt with cause-based rather than event-based aggregation).

- I15. Reinsured H issued a policy of insurance "covering the liabilities of 14 directors, officers and employees of an American financial institution". The

institution “collapsed and a claim was made against [all] 14 of the directors and officers, each of whom was alleged to be personally liable” for having been “negligent or otherwise at fault in [the] handling of [the institution’s] affairs”.

The relevant events were “the acts or omissions of the directors, officers and auditors, not the subsequent collapse of [the institution]” (*American Centennial Insurance Company v INSCO Limited* [1996] WL 1093224). Therefore, it is not possible to aggregate all of the individual losses resulting from the collapse of the institution.

- C17. A primary insured’s omission may only be considered an event if the omission itself directly triggered the primary insured’s liability (pure omission). By contrast, dormant omissions do not themselves trigger the insured’s liability but require some further positive act or event. So long as the negligent individual remains passive, no actionable harm ensues in such cases (LOUW AND TOMPKINSON 11).

Illustrations

- I16. A solicitor was required to issue a writ which he failed to do before the deadline. The omission to file the writ itself without any requirement of positive action caused the harm. Hence, the solicitor’s failure can be considered a pure omission and is consequently an event according to Article 5.2 paragraph (2) (cf. *Forney v Dominion Insurance Co Ltd* [1969] 1 WLR 928).
- I17. An underwriter underwrote multiple contracts without researching a particular risk. He does not incur any liability for not having researched the risk. Rather, his state of ignorance becomes relevant only if he undertakes the further positive acts of underwriting the insurance contracts. Thus, the omission to research the said risk must be considered a dormant omission which does not amount to an aggregating event (cf. *Caudle v Sharp* [1995] CLC 642, 649). By contrast, each positive act of underwriting a contract is to be considered an event.
- C18. Equally, a fact giving rise to the primary insured’s liability can be considered an event. Any happening that directly triggers the primary insured’s liability in the absence of any fault may be considered such a fact.

Illustration

- I18. Without any fault on the part of the driver, one of a car’s tires blew out and resulted in a multi-person accident on a highway. The operational risk of a driving car has materialized and triggered the driver’s strict liability. Hence, even in the absence of any negligent act or omission on the part of the driver, the latter becomes liable to indemnify third parties involved in the accident. For the purposes of aggregating losses, the fact that the accident happened is to be considered the relevant event.

C19. In Article 5.2 paragraph (2), it is stated that any act, omission or fact “for which the primary insured is or allegedly is liable” may constitute an event for the purpose of aggregating losses. This specification ensures that aggregation is possible even if the primary insured’s liability cannot be evidenced by court verdict or arbitral award. In fact, whenever a reinsured becomes liable towards a primary insured, an aggregation of losses is possible provided, of course, that all the losses are covered under the contract.

c. Direct consequence

C20. It is not appropriate to aggregate every loss that arises from the same event. Rather, losses are to be aggregated only if they are the direct consequence of the relevant event, i.e. an instance of materialized peril reinsured against or a liability triggering act, omission or fact.

C21. Therefore, the 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 consequence. The notion of “direct consequence” under the PRICL is not to be confounded with the notion of proximate or efficient cause under English or US law.

C22. A loss may be considered an event's direct consequence if it can be considered an inevitable effect 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.

C23. This does, however, not mean that the relevant event, i.e. an instance of materialized peril or a liability triggering act, omission or fact, 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.

Illustration

I19. Reinsured A takes out reinsurance for a first-party property insurance policy against the perils of earthquake and tsunami. An earthquake occurs and causes losses 1 and 2. At the same time, a tsunami is triggered by the earthquake. Losses 3 and 4 arise from the tsunami.

Each loss must be tested individually. In particular, it is to be determined whether losses 1 - 4 can be considered direct consequences of the relevant event, i.e. the earthquake. Losses 1 and 2 occurred due to the earthquake, whereas losses 3 and 4 resulted from the tsunami which, in turn, was triggered by the earthquake.

As the tsunami was an inevitable consequence of the earthquake, losses 3 and 4 may be considered direct consequences of the earthquake. Hence, losses 1 - 4

are to be aggregated, even though the earthquake did not immediately precede losses 3 and 4.

- C24. The chain of causation between the relevant event and a loss can be considered broken if an intervening factor decisively interferes. This factor must be independent from the relevant event, i.e. the materialization of the peril reinsured against (paragraph (1)) or the liability triggering act, omission or fact (paragraph (2)). It may be constituted in a person omitting to prevent the event from happening if this person was under a duty of care to avert the corresponding losses. In such a case, the test is whether the corresponding losses would not have arisen, had the person acted in compliance with his duties (*conditio cum qua non*). Such an omission may occur before or after the relevant event.

Illustrations

- I20. Reinsured A takes out reinsurance for a first-party property insurance policy against the perils of earthquake and fire. An earthquake occurs and causes losses 1 and 2. At the same time, a tsunami is triggered by the earthquake and results in a short circuit because electric cables have not been insulated according to the required standards. The short circuit causes a fire from which losses 3 and 4 arise.

The lack of proper insulation of the electric cables can be considered an intervening factor sufficient to break the chain of causation. Losses 3 and 4 cannot be considered direct consequences of the earthquake. Thus, losses 3 and 4 are not to be aggregated with losses 1 and 2.

- I21. Reinsured B takes out reinsurance for a first-party property insurance policy against the perils of earthquake and fire. An earthquake occurs and causes losses 1 and 2. At the same time, a tsunami is triggered by the earthquake and results in a short circuit. All of the electric cables were insulated in accordance with the required standard but broke as a result of the earthquake. The short circuit results in a fire which causes losses 3 and 4.

As the short circuit and the resulting fire can be considered inevitable consequences of the earthquake and the tsunami, neither can be considered a decisively intervening factor. Losses 3 and 4 are to be aggregated with losses 1 and 2.

- I22. Primary insured C negligently injures a company's director D who must subsequently be hospitalized. Treatment costs result in loss 1. Due to the absence of director D, deputy director E is in charge. The latter makes some unfortunate decisions which result in losses 2 and 3.

The company is under a duty to organize its affairs appropriately. It is under a specific duty to ensure that the company is able to operate in case of director D's absence. Thus, the company's failure to hire a capable deputy director can be considered an intervening factor sufficient to break the chain of causation. Losses 2 and 3 cannot be considered the direct consequence of the primary

insured's negligent act. Thus, losses 2 and 3 are not to be aggregated with loss 1.

- I23. Reinsured F takes out reinsurance for a landowner's third-party liability insurance policy. An airplane flies into a building and thereby injures some of the landowner's employees (losses 1 - 10; workers' compensation claims) for which the primary insured became liable. In the time after the accident, there is a massive clean-up operation by the landowner. Evidence shows that the clean-up workers have been negligently exposed to asbestos during the clean-up operations. The workers' exposure resulted in losses 11 - 50 for which the primary insured is equally liable (respiratory claims). Consequently, the landowner is liable for losses 1 - 50.

The respiratory losses did not arise from the same event as the workers' compensation claims, i.e. the airplane accident. This is so because the landowner is under a duty of care to protect the clean-up workers from injuries by providing them with adequate protective equipment. The landowner's failure to provide such protection can be considered an intervening factor sufficient to break the chain of causation between the airplane accident and respiratory claims. Therefore, the workers' compensation claims are not to be aggregated with the respiratory claims (cf. *Mic Simmonds v AJ Gammell* [2016] EWHC 2515 where a different conclusion was reached).

- C25. Similarly, an intervening factor sufficient to break the chain of causation may be constituted in a happening which occurs independently of the event reinsured against and which inevitably results in the corresponding losses (*conditio sine qua non*). Such a happening may occur before or after the relevant event.

Illustrations

- I24. Reinsured A takes out all risk reinsurance for a first-party property insurance policy. A bushfire spreads and causes losses 1 and 2. At the same time, it destroys vegetation on a slope so that the ground is unable to absorb larger amounts of water. Eight months later, during extraordinary heavy rainfalls, a landslide occurs and losses 3 and 4 result.

The materialization of the peril of fire constitutes the event within the meaning of Article 5.2 paragraph (1). Losses 3 and 4 occurred due to a combination of the destroyed vegetation and the heavy rain. The bushfire alone would not have caused losses 3 and 4, which means that the instance of heavy rain may be considered a decisively intervening factor independent of the relevant event. Therefore, losses 3 and 4 are not to be aggregated with losses 1 and 2.

- I25. Reinsured B takes out all risk reinsurance for a first-party property insurance policy. A vessel spills a significant amount of oil into the sea near the coast. Some days later, a windstorm occurs and blows some of the spilled oil into a river. Due to the strength of the windstorm, it eventually causes a flood. Losses 1 and 2 arise from the destructive force of the flood. Furthermore, in the course

of the flood, some of the oil pollutes nearby agricultural land which results in losses 3 and 4.

The flood constitutes the event within the meaning of Article 5.2 paragraph (1). Losses 3 and 4 occurred due to a combination of the oil spillage and the windstorm. Hence, losses 3 and 4 would not have occurred had there not been an independent oil spillage. Therefore, losses 3 and 4 are not to be aggregated with losses 1 and 2.

- I26. Reinsured C takes out reinsurance for a professional liability insurance policy. A vessel owner negligently spills a significant amount of oil into the sea near the coast which results in the pollution of the coastal area and thereby triggers his liability (losses 1 and 2). Some days later, an unusually heavy windstorm occurs and blows some of the spilled oil into a river and eventually causes a flood. In the course of the flood, some of the oil pollutes nearby agricultural land resulting in losses 3 and 4.

Losses 3 and 4 occurred due to a combination of the oil spillage and the flood. Hence, the vessel owner's negligent act alone would not have caused losses 3 and 4, which means that the flood may be considered a decisively intervening factor independent of the relevant event (negligent spillage of oil). Therefore, losses 3 and 4 are not to be aggregated with losses 1 and 2.

- C26. If an intervening factor contributes to the occurrence of a loss but cannot be said to be decisive for the occurrence of the loss, such intervening factor cannot prevent the aggregation of this loss with other losses resulting from the relevant event. For instance, common circumstances in place at the time the peril reinsured against materializes (e.g. common wind which spreads the fire to adjacent properties) or the primary insured's liability is triggered are generally not considered decisively intervening factors although they may support the occurrence of losses.

Illustrations

- I27. Reinsured A takes out reinsurance for a first-party property insurance policy against the perils of tsunami and fire. A tsunami occurs and causes losses 1 and 2. At the same time, the tsunami causes a short circuit which results in a fire that easily spreads because of the common wind conditions. Losses 3 and 4 occur.

As the short circuit can be considered the inevitable consequence of the tsunami, losses 1 - 4 are to be aggregated. The fact that losses 3 and 4 only occur due to the common wind conditions does not make such conditions an independent and decisively intervening factor.

- I28. Reinsured B takes out reinsurance for a portfolio of personal liability insurance policies. Primary insured C negligently sets fire to a building which results in loss 1. Due to the common wind conditions in the area the fire spreads and causes losses 2 and 3.

Losses 2 and 3 can be considered the direct consequence of the primary insured's negligent act. The commonly windy weather cannot be considered a decisively intervening factor that breaks the chain of causation. Therefore, losses 1 - 3 are to be aggregated.

- I29. Reinsured D takes out reinsurance for a portfolio of personal liability insurance policies. Primary insured E negligently sets fire to a building which results in loss 1. Shortly thereafter, a seldom heavy windstorm occurs and causes the fire to spread. Losses 2 and 3 occur.

Losses 2 and 3 occurred due to a combination of the fire and the seldom windstorm. Hence, E's negligent act alone would not have caused losses 2 and 3, which means that the windstorm may be considered a decisively intervening factor independent of the relevant event (negligently setting fire). Therefore, losses 2 and 3 are not to be aggregated with loss 1.

4. Sublimits

- C27. Reinsurance contracts typically not only contain coverage limits but also sublimits. Sublimits define a limit of liability with respect to a particular peril when the contract provides coverage against a multitude of perils or with respect to a specific reinsured asset when reinsurance is taken out for a multitude of different assets or with respect to a specific location when the reinsured assets are located at a multitude of places.
- C28. Under the PRICL, aggregation is dealt with on each level of limits, i.e. total coverage limits, sublimits and sub-sublimits. Thus, event-based aggregation of losses is subject to any coverage limits specified in the contract.

Illustrations

- I30. There is reinsurance coverage per occurrence with a total coverage limit of USD 40 million. The contract states a USD 20 million sublimit per occurrence for the peril of tsunami.

An earthquake occurs and causes losses amounting to USD 30 million. The earthquake further directly results in a tsunami which causes tsunami losses amounting to USD 30 million. The event caused damage totaling USD 60 million. Both earthquake and tsunami losses can be considered direct consequences of the earthquake, so that generally all of the losses can be aggregated.

In order to respect the different sublimits, however, it is necessary to test whether the aggregate tsunami loss is within the tsunami cover limit. This is not the case. USD 20 million of the tsunami losses are covered by the sublimit specified for tsunami losses, while the remaining USD 10 million of the tsunami losses are not.

Another necessary test is whether the aggregate loss that results from the event is within the total coverage limit. Losses caused by the tsunami can be

considered losses caused by the earthquake. Therefore, all the covered tsunami losses are aggregated with the earthquake losses. They amount to USD 50 million (USD 20 million tsunami losses and USD 30 million earthquake losses). The total coverage limit is USD 40 million, meaning that losses amounting to another USD 10 million are not covered.

- I31. Reinsured A takes out aviation reinsurance for a public liability insurance policy. The reinsurance coverage is per occurrence with a total coverage limit of USD 40 million. The contract states a USD 20 million sublimit per occurrence for damage caused by the release of substances hazardous to soil or water.

Due to a wrong manipulation by the pilot, the primary insured's aircraft negligently releases liquid fuels which results in the pollution of agricultural land. The damage amounts to USD 30 million. The leakage of the fuels further results in a crash that causes property damage in the amount of USD 30 million. The event causes damage totaling USD 60 million.

Both the pollution and the property damage losses can be considered direct consequences of the pilot's wrong manipulation. In order to respect the different sublimits, however, it is necessary to test whether the aggregate pollution loss is within the pollution sublimit. This is not the case. USD 20 million of the pollution losses are covered by the sublimit specified for pollution losses, while the remaining USD 10 million of the pollution losses are not.

Another necessary test is whether the aggregate loss that results from the event (wrong manipulation) is within the total coverage limit. Both pollution and property damage losses can be considered losses caused by the pilot's wrong manipulation. Therefore, all the covered pollution losses are aggregated with the property damage losses. They amount to USD 50 million (USD 20 million pollution losses and USD 30 million property damage losses). The total coverage limit is USD 40 million, meaning that losses amounting to further USD 10 million are not covered under the contract.

5. Treaty reinsurance

- C29. In the case of treaty reinsurance, a reinsured takes out reinsurance against a multitude of risks covered by multiple primary insurance policies under a single contract.
- C30. If multiple first-party primary insurance policies are triggered as a result of the same materialization of a peril reinsured against, multiple losses occur under the contract. Under Article 5.2 paragraph (1), these losses are treated as one single loss with regard to reinsurance retention (deductible) and coverage limit.

Illustration

- I32. A reinsured takes out reinsurance for a reinsurance portfolio of car property damage policies. The peril insured against is destruction by accident. Several

car accidents occur under different primary insurance policies in the reinsurance portfolio. As the accidents occur independently of one another, the peril insured against materializes in multiple instances so that the individual losses incurred by the different car owners cannot be aggregated for the purpose of aggregating losses under the reinsurance treaty.

By contrast, if a multiple collision accident occurs so that the first car crash was causative for any of the other crashes involved, the first car crash can be considered the materialization of the peril insured against. Any losses that directly originate from this first car accident are to be aggregated under the PRICL (cf. *Hartford Accident & Indemnity Co v Wesolowski*, 33 NY2d 169, 910 with regard to a primary liability insurance case). The fact that the accident triggered a multitude of primary insurance policies does not conflict with the aggregation of losses under Article 5.2 paragraph (1).

- C31. It should be noted that it is generally not possible for one event to trigger multiple third-party primary insurance policies as third-party liability risks are normally covered in only one primary insurance policy. Thus, if this primary insurance policy is triggered, the other primary insurance policies under the reinsurance treaty remain unaffected.

6. Hours clauses

- C32. Catastrophe excess of loss contracts in particular often contain hours clauses defining a time frame within which losses arising from an event are to be aggregated. Regularly, such clauses refer to a “catastrophe” as the unifying factor for the aggregation of losses. Under the PRICL, a “catastrophe” equates to any other event (cf. Article 5.2 Comment C1 above), therefore Article 5.2 paragraph (1) applies. However, hours clauses tend to narrow down the scope of the aggregation mechanism provided for in Article 5.2 paragraph (1).

- C33. Where the parties include an hours clause, Article 5.2 paragraph (1) will to some extent be altered. In such a case, the relevant event is still determined pursuant to Article 5.2 paragraph (1) and it still applies that only losses directly occasioned by this event may be aggregated. The parties then, however, amend the mechanism provided for in the PRICL in that they specify that only losses that occur within the time frame agreed upon in the hours clause aggregate.

7. Life insurance policies

- C34. Under Article 5.2 paragraph (1), life insurance policies are equated with first-party insurance policies where appropriate. In life insurance, a primary insurer pays a stipulated sum of money to the designated beneficiaries upon death of the insured.
- C35. A primary insured’s death is to be considered the loss suffered. As an insured can only lose his life once, there can only be one loss per individual life insurance policy. Therefore, loss aggregation is irrelevant in primary life insurance.
- C36. By contrast, if a portfolio of primary life insurance policies is reinsured, the reinsurance treaty may provide for a retention, coverage limit and coverage sublimit for the whole

portfolio rather than for each primary life insurance policy. In this case, the question of aggregating losses arises.

- C37. Generally, life insurance is all-risk insurance subject to the exclusion of a number of risks. Unless a certain cause of death has been excluded from the policy's scope of coverage, the insurance payment becomes due once the primary insured has died. The primary insured's cause of death is to be considered the aggregating event, whereas his death is the loss. Therefore, an event, under the PRICL, is the materialization of any risk (cause of death) not specifically excluded from the life insurance policy's scope of coverage.
- C38. If multiple losses originate in the same materialization of a risk, they may be aggregated for the purpose of loss aggregation (Article 5.2 paragraph (1)). As life insurance policies generally cover all-risks, any event (cause of death) responsible for the death of multiple people may be considered the relevant event for the purpose of aggregating losses.

Illustrations

- I33. Multiple people die from an earthquake. Each insured's death may be considered a loss. As all of the losses directly originated in the earthquake, they are to be aggregated.
- I34. Multiple people die of lung cancer. Each insured's death may be considered a loss. However, the development of the illness is a separate instance of materialized peril for each insured. Hence, the individual losses are not to be aggregated.
- I35. Multiple people die of the exact same virus strain. The outbreak of the respective virus and the subsequent infection of people can be considered one instance of materialized peril and the individual deaths can be considered a direct consequence of the materialization. Hence, the individual losses are to be aggregated.

8. Bundled insurance products

- C39. If a primary insurance policy contains aspects of first- and third-party insurance, it may be that an instance of materialized peril (first-party) coincides with the liability triggering act, omission or fact (third-party). In such cases, losses under the first-party insurance are to be aggregated with losses under the third-party insurance.

Illustration

- I36. Primary insured A takes out property car insurance as well as liability car insurance. He commits a car accident in negligence, whereby his and another driver's cars are both damaged. Under the first-party property car insurance, the peril of damage by accident materialized when the accident occurred. Thus, the accident can be said to be the event for the purposes of Article 5.2 paragraph (1). Simultaneously, by negligently committing the accident, the driver

triggered his liability under the third-party insurance. Thus, the accident can also be considered the event for the purposes of Article 5.2 paragraph (2). As the events under these two provisions are identical, the respective losses are to be aggregated.

ARTICLE 5.3

(Cause-based aggregation)

(1) Where the parties agree on a cause-based aggregation in a contract reinsuring first-party insurance policies, all losses that occur as the direct consequence of one or multiple events within the meaning of Article 5.2 paragraph (1) shall be considered as arising out of one common cause if it was reasonably foreseeable that a cause of this kind could give rise to such an event.

(2) Where the parties agree on a cause-based aggregation in a contract reinsuring third-party insurance policies, all losses that occur as the direct consequence of one or multiple events within the meaning of Article 5.2 paragraph (2) shall be considered as arising out of one common cause if it was reasonably foreseeable that a cause of this kind could give rise to such an event.

COMMENTS

1. Individual losses

C1. For the notion of individual losses, see Article 5.2 Comment C2.

2. Originating or original cause (paragraphs (1) and (2))

C2. Under the PRICL, the unifying factor of “cause” allows for a wider aggregation than “event”. Furthermore, in the PRICL, the notions of “cause” and “source” are equated. Thus, whenever a contract refers to the unifying factor of “source” the parties agree on an aggregation pursuant to Article 5.3.

C3. An aggregating cause may provoke multiple instances of materialized perils or liability triggering acts, omissions or facts each of which may result in a plurality of losses. Under cause-based aggregation, any losses that arise from such a cause are aggregated no matter the number of instances a peril materialized or the number of liability triggering acts, omissions or facts.

C4. Similarly, the reinsured may take out reinsurance against multiple perils in one contract. If a cause within the meaning of Article 5.3 leads to the materialization of multiple different perils reinsured against or multiple different liability triggering acts, omissions or facts, such cause is the unifying factor not only for any losses resulting from multiple instances of the materialization of the same peril or multiple identical liability triggering acts, omissions or facts, but also for losses resulting from the materialization of different perils or different liability triggering acts, omissions or facts.

Illustration

- II. Reinsured A takes out reinsurance against the perils of tsunami and fire. An earthquake occurs and provokes a tsunami and a fire independently of one another. Multiple losses result from the tsunami and multiple losses result from the fire.

The peril of tsunami materialized in one instance, as did the peril of fire. Within the meaning of Article 5.2 paragraph (1), the materialization of the peril of tsunami is considered an event distinct from the materialization of the peril of fire. In the ordinary course of things, it appears quite likely that an earthquake will result in both the materialization of a tsunami and the materialization of a fire. Under Article 5.3 paragraph (1), the earthquake is, therefore, to be considered the unifying cause. Any losses that can be considered the direct consequence of either the fire or the tsunami are aggregated under Article 5.3 paragraph (1).

- C5. As illustrated, the concept of “cause” is much wider than the concept of “event”. In fact, a cause may be the reason why an event occurred. More specifically, a state of affairs (*Axa Reinsurance (UK) Plc v Field* [1996] 1 WLR 1026, 1035), a state of ignorance (*Axa Reinsurance (UK) Plc v Field* [1996] 1 WLR 1026, 1030), the lack of proper training (*Countrywide Assured Group Plc v Marshall* [2002] WL 31173646, 6), a misunderstanding as to the results of discussions (*American Centennial Insurance Company v INSCO Limited* [1996] WL 1093224, 8) and a failure of putting in place an adequate system to protect goods (*Municipal Mutual Insurance Ltd v Sea Insurance Ltd* [1998] CLC 957, 967) may be considered causes for the purpose of aggregating losses.

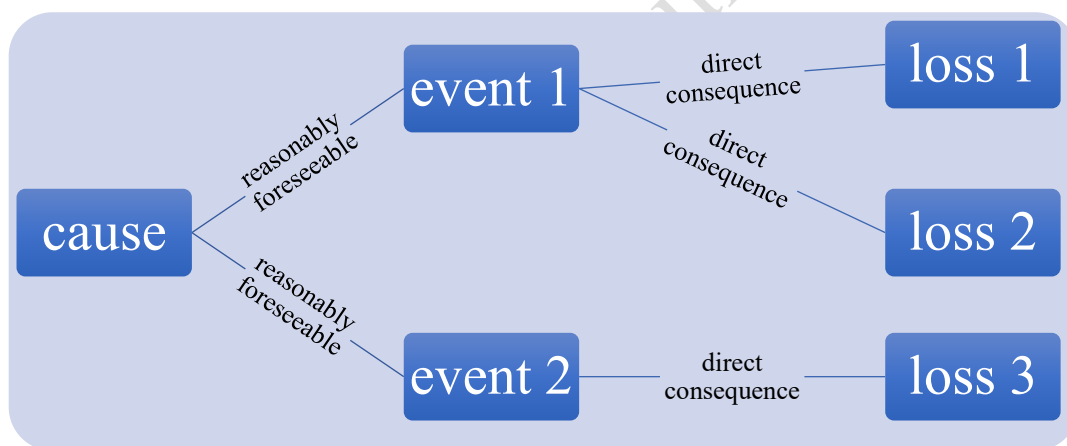
3. Causation

a. Causation in general

- C6. There must be a causative link between the relevant cause on the one hand and any losses to be aggregated on the other hand. This involves a three-step analysis:
- C7. First, any loss covered under the contract results from an instance of materialized peril reinsured against or a liability triggering act, omission or fact, i.e. an event within the meaning of Article 5.2. The relevant event or events as defined in Article 5.2 is/are to be determined and pinpointed on the chain of causation. For more details as to this test, see Article 5.2 Comments C6 et seqq.
- C8. Secondly, to find the aggregating cause as defined in Article 5.3, it is necessary to move further back in the chain of causation. It is to be determined whether there is a cause that triggered one or multiple events within the meaning of Article 5.2. If there is no such cause, the materialization of a peril reinsured against or the liability triggering act, omission or fact is to be considered the aggregating cause. In this case, an event within the meaning of Article 5.2 equates to a cause within the meaning of Article 5.3.
- C9. By contrast, if there is a cause from which one or multiple events (Article 5.2) originated, it is necessary to test whether it was reasonably foreseeable that such a cause would provoke one or multiple such events (Article 5.2). If so, this cause is to be

considered the aggregating cause within the meaning of Article 5.3. It is distinct from one or multiple events within the meaning of Article 5.2. It is important not to give a court or arbitral tribunal the leeway to consider the materialization of a peril reinsured against or the liability triggering act, omission or fact the relevant cause within the meaning of Article 5.3. Otherwise, the parties' choice for a broader aggregation mechanism would be disregarded.

- C10. Thirdly, not every loss arising from an event which in turn originates in such an aggregating cause may be aggregated. Rather, the only losses that are aggregated are those that can be said to arise as a direct consequence of the materialization of the peril reinsured against or the liability triggering act, omission or fact.
- C11. Consequently, the standard of “reasonable foreseeability” operates between the aggregating cause within the meaning of Article 5.3 and the materialization of a peril reinsured against or a liability triggering act, omission or fact, i.e. an event within the meaning of Article 5.2. By contrast, the standard of “direct consequence” operates between an event within the meaning of Article 5.2 and the individual losses. This is illustrated below.



b. Reasonable foreseeability

- C12. A cause may be somewhere further back in the chain of causation than an event. The concept of reasonable foreseeability is meant to restrict how much further back in the chain of causation a court or arbitral tribunal may look in the search for an aggregating cause. In fact, not every cause that provokes an instance of materialized peril can be considered an aggregating cause within the meaning of Article 5.3. If a cause is too loosely connected to the event to justify an aggregation of losses, it cannot be considered an aggregating cause within the meaning of Article 5.3.
- C13. Under Article 5.3, a cause may be considered the unifying factor for the purpose of aggregating losses, if it was reasonably foreseeable to the parties that – in the ordinary course of things – a cause of this kind would lead to an event of the kind under consideration, i.e. an instance of materialized peril (Article 5.2 paragraph (1)) or an act, omission or fact that triggers the primary insured's liability (Article 5.2 paragraph (2)).

In other words, a cause is the unifying factor if – in the ordinary course of things – it appears somewhat likely that an event within the meaning of Article 5.2 would occur as the result of such cause.

- C14. Consequently, it is not necessary for it to be reasonably foreseeable that a cause would provoke multiple events or that the events which flowed from the cause would eventually result in a plurality of losses. Similarly, the number of separate losses that may arise from an event originating from the cause in question or the extent of such losses does not have to be reasonably foreseeable. Rather, it is sufficient that it is reasonably foreseeable that a cause of the kind in question may lead to an event of the kind in question.
- C15. The requirement of reasonable foreseeability is an objective one. Whether a certain cause was reasonably foreseeable must be determined by reference to a reasonable person in the circumstances of the parties. Furthermore, reasonable parties judge the standard of foreseeability in light of the ordinary course of things.
- C16. It is at the time of entering into the contract that reasonable parties must have been able to reasonably foresee that a cause of the kind in question might result in one or more reinsured events.
- C17. In any case, it is important to note that the concept of foreseeability in Article 5.3 does not correspond with the concept of foreseeability in tort law or the concept of foreseeability in general contract law or insurance law (cf. SWISHER, Insurance Causation Issues: The Legacy of *Bird v St Paul Fire & Marine Ins Co* 361 et seq. for the distinction between the different concepts).
- C18. In fact, in tort law, the concept of foreseeability is used to determine “whether [someone’s] act, or omission to act, was too remote or did in fact constitute the proximate cause” of the injured’s damage and therefore triggered the wrongdoer’s liability (SWISHER, Causation Requirements in Tort and Insurance Law Practice: Demystifying Some Legal Causation Riddles 9). In general contract law, the concept of foreseeability is used to limit a party’s liability for breach of contract (§ 351(1) Restatement (Second) of Contracts). In insurance law, the concept of foreseeability is used to determine whether a certain loss is covered by the insurance policy (cf. SWISHER, Insurance Causation Issues: The Legacy of *Bird v St Paul Fire & Marine Ins Co* 361 et seqq.). In all of these cases, the concept of foreseeability is used to limit liability.
- C19. The PRICL do not use the concept of reasonable foreseeability to limit the reinsurers’ liability, i.e. to determine whether a certain loss is covered under the contract. Rather, the question of whether these separate losses are to be aggregated only arises once it has been established that a plurality of losses are generally covered by the contract. In fact, limiting the extent of aggregation may – depending on both the structure of the reinsurance policy and the structure of the individual losses – lead to an increase or decrease in a reinsurer’s liability.

Illustrations

- I2. Under the primary insurance policy, Reinsured A provides professional liability insurance to primary insured B. B is an insurance underwriter who underwrites a plurality of insurance contracts without appreciating the risk of asbestosis. Reinsurer C provides reinsurance coverage to A for the third-party liability insurance policy between A and B.

It must be determined whether, at the time of contract formation, it was reasonably foreseeable that – in the ordinary course of things – an underwriter's liability would be triggered if the latter underwrote insurance contracts without having appreciated all of the known risks.

The risk of asbestosis was public knowledge at the time B underwrote the insurance contracts. It may be said that it was reasonably foreseeable that an underwriter's ignorance about this risk would lead to an act of negligent underwriting. Consequently, the underwriter's ignorance is to be considered a cause within the meaning of Article 5.3. This is so because – in the ordinary course of things – it cannot be considered highly unlikely that the lack of appreciation of such a significant risk as asbestosis would eventually trigger B's liability. Therefore, under Article 3.1.3(2), any losses that originated in B's ignorance are to be aggregated.

- I3. Reinsured D takes out property reinsurance for banks against the peril of damage or theft. In the course of five months, multiple instances of robbery occur independently of one another. Sociological experts have opined that these instances of theft could be considered a sign of the increasing materialism in society.

The peril “theft” materialized in several instances. Each instance of materialization is to be considered a distinct event for the purpose of Article 5.2 paragraph (1). From the perspective of reasonable parties to a contract reinsuring property risks, it appears highly unlikely that – in the ordinary course of things – separate instances of theft would occur because of such a thing as increasing materialism in society. For lack of reasonable foreseeability, increasing materialism in society cannot be considered a unifying cause under Article 5.3 paragraph (1).

- C20. Like the concept of proximity (cf. Article 5.1 Comments C21 et seqq.), the concept of reasonable foreseeability is generally open to result-oriented judgments and can, hence, be considered unclear to some degree. In full awareness of this fact, the concept of reasonable foreseeability is used in Article 5.3, in which a standard is thereby adopted which may – under certain circumstances – not be clear-cut, but that is nevertheless able to reduce legal uncertainty to some degree.

c. Direct consequence

- C21. It is not appropriate to aggregate every loss that arises from the same event which in turn originates in a cause within the meaning of Article 5.3. Rather, the only losses that

are to be aggregated are those that are a direct consequence of the relevant event, i.e. an instance of materialized peril reinsured against or a liability triggering act, omission or fact.

- C22. Therefore, the necessary test is whether an individual loss can be considered a direct consequence of the relevant event within the meaning of Article 5.2. In order to ensure this, just as under Article 5.2, only the strength of the causal links between the instances of materialized perils or liability triggering acts, omissions or facts on the one hand and the corresponding losses on the other hand are to be tested. For the test of whether a loss can be said to be a direct consequence of an instance of materialized peril, see Article 5.2 Comment C20 et seqq.
- C23. By contrast, the “direct consequence” test does not involve determining the degree of causation between the aggregating cause within the meaning of Article 5.3 and the individual losses.

Illustrations

- I4. Reinsured A takes out property reinsurance for a large number of buildings against the peril of tsunami with the peril of earthquake excluded. An earthquake occurs and leads to multiple separate tsunamis each of which damages some buildings.

The peril of tsunami materializes in several instances. Each instance of materialization is to be considered a distinct event for the purposes of Article 5.2 paragraph (1). After having determined the plurality of tsunamis as multiple events, it is necessary to move further back on the chain of causation in the search for an aggregating cause that provoked each of the tsunamis. In the ordinary course of things, it is quite likely that an earthquake may result in a tsunami. Under Article 5.3 paragraph (1), the earthquake is, therefore, to be considered the unifying cause. The fact that the peril of earthquake is excluded from the coverage under the contract does not bar the earthquake from figuring as the aggregating cause under Article 5.3 paragraph (1).

The final step is to determine whether each loss can be considered to be a direct consequence of the respective tsunami. Any losses that can be considered a direct consequence of any of the tsunamis are aggregated under Article 5.3 paragraph (1).

- I5. Reinsured B takes out property reinsurance for a large number of supermarket stores against the peril of damage or destruction by vandalism. After the country’s president resigns, 22 stores are damaged by rioters in a number of instances of vandalism over a period of some two days. The rioters are said to be centrally orchestrated by the government. Having determined that the plurality of acts of vandalism are multiple events, it is necessary to move further back on the chain of causation in search of an aggregating cause that provoked each of the acts. In the ordinary course of things, it appears quite likely that a centralized orchestration of political rioters would lead to one or

more instances of vandalism. Under Article 5.3 paragraph (1), the rioters' centralized orchestration is, therefore, to be considered the aggregating cause.

The final step is to determine whether each loss can be considered to be a direct consequence of the respective act of vandalism. Any losses that can be considered a direct consequence of any of the acts of vandalism are aggregated under Article 5.3 paragraph (1) (cf. *Mann & Anor v Lexington Insurance Co* [2000] CLC 1409 which dealt with event-based aggregation).

16. Reinsured C takes out property reinsurance for a large number of supermarket stores against the peril of damage or destruction by vandalism. After the market price of cigarettes increases substantially, 22 stores are damaged independently of one another by rioters in a number of instances of vandalism over a period of some two days. A majority of rioters declare to have vandalized due to a substantial increase in the market price of cigarettes. Having determined the plurality of acts of vandalism as multiple events, it is necessary to move further back on the chain of causation in search of an aggregating cause that provoked each of the acts.

In the ordinary course of things, it appears to be highly unlikely that a rise in the market price of cigarettes would lead to one or more instances of vandalism. For lack of reasonable foreseeability, the increase in the cigarettes' market price cannot be considered a unifying cause under Article 5.3 paragraph (1).

17. Reinsured D provides professional indemnity insurance to a managing agent of a syndicate at Lloyd's. Due to the latter's "culpable misappreciation", he successively fails "to pay sufficient regard to proper principles of underwriting". After having incurred gross losses, the members of the syndicate bring action in negligence against the managing agent.

With each act of underwriting in disregard of the "proper principles of underwriting", the managing agent triggered his liability. Hence, each act of underwriting constitutes a separate event for the purposes of Article 5.2 paragraph (2). Having determined that each act of underwriting constitutes a separate event, it is necessary to move further back on the chain of causation in search of an aggregating cause that provoked each of these underwritings. It appears quite likely that an underwriter who is unaware of the proper underwriting principles would negligently underwrite contracts and thereby incur liability. Consequently, the agent's culpable misappreciation "[...] can [...] be said to constitute the single [...] originating cause responsible for all the negligent acts [...]" and can, hence, be considered a common cause for the purposes of Article 5.3 paragraph (2).

The final step is to determine whether each loss can be considered to be a direct consequence of the respective act of underwriting. Any losses that can be considered a direct consequence of any of the acts of underwriting are aggregated under Article 5.3 paragraph (2) (cf. *Cox v Bankside Members Agency Ltd* [1995] CLC 180).

18. Reinsured E issues a policy of insurance “covering the liabilities of 14 directors, officers and employees of an American financial institution”. The institution “collapsed and a claim was made against [all] 14 of the directors and officers, each of whom was alleged to be personally liable” for having been “negligent or otherwise at fault in [the] handling of [the institution’s] affairs”. Any faults committed by the directors and officers can be said to be the consequence of “a common culpable misunderstanding as the result of a discussion between them on which they all subsequently acted”.

Each negligent act or fault triggers the respective directors’ and officers’ liability. Thus, each negligent act or fault can be considered a separate event for the purposes of Article 5.2 paragraph (2). Having determined that each act constitutes a separate event, it is necessary to move further back on the chain of causation in search of an aggregating cause that provoked each of these acts. It appears quite likely that directors and officers would reach a common misunderstanding that might translate into multiple wrongful acts or omissions. Hence, their discussion that resulted in the misunderstandings can be regarded as the common cause for the purposes of Article 5.3 paragraph (2).

The final step is to determine whether each loss can be considered to be a direct consequence of the respective act. Any losses that can be considered a direct consequence of any of the acts are aggregated under Article 5.3 paragraph (2) (cf. *American Centennial Insurance Company v INSCO Limited* [1996] WL 1093224).

19. Reinsured F provides liability insurance to a port. Equipment stored at the port is “vandalised by a succession of individual acts of pilferage.” The owner of the equipment brings action against the port for not putting in place an “adequate system to protect the goods from pilferage and vandalism”.

The port’s liability is triggered by each act of vandalism it is unable to avert. Thus, each instance of vandalism the port was unable to avert can be considered a separate event for the purposes of Article 5.2 paragraph (2). Having determined that each act constitutes a separate event, it is necessary to move further back on the chain of causation in search of an aggregating cause that provoked each of these omissions to avert acts of vandalism. The port’s inability to avert these instances of vandalism originated in its failure to put in place an adequate system of protection from pilferage and vandalism. It appears likely that stored goods would be vandalized if no system of protection were put in place, the port’s failure can be regarded as a common cause for the purposes of Article 5.3 paragraph (2).

The final step is to determine whether each loss can be considered to be a direct consequence of the respective omission to avert acts of vandalism. Any losses that can be considered a direct consequence of any of these omissions are aggregated under Article 5.3 paragraph (2) (cf. *Municipal Mutual Insurance Ltd v Sea Insurance Co Ltd* [1998] CLC 957, 966 et seqq.).

- I10. Reinsured G provides professional indemnity insurance to primary insured H – an insurance company. Several of H’s underwriters mis-sell pensions for which they are held liable. They are found to have done so due to their “lack of proper training”.

H’s liability is triggered by each instance of mis-selling a pension. Therefore, each instance of mis-selling can be considered a separate event for the purposes of Article 5.2 paragraph (2). Having determined that each act of mis-selling constitutes a separate event, it is necessary to move further back on the chain of causation in search of an aggregating cause that provoked each of these instances of mis-selling. It appears quite likely that not providing the sales personnel with adequate sales training would lead to the mis-selling of pensions. Therefore, the lack of proper training can be considered a common cause for the purposes of Article 5.3 paragraph (2).

The final step is to determine whether each loss can be considered to be a direct consequence of the respective instance of mis-selling. Any losses that can be considered a direct consequence of any of these instances of mis-selling are to be aggregated under Article 5.3 paragraph (2) (cf. *Countrywide Assured Group Plc v Marshall* [2002] WL 31173646, 6).

- I11. Reinsured I provides professional indemnity insurance to J, “a chemical manufacturer that has operated in locations throughout the United States since the early 1900s.” In the 1980s, federal, state and local governments as well as a number of private parties commenced environmental actions directed at more than 150 of the manufacturer’s plant and disposal sites throughout the country. Experts have found that the pollution originated in the manufacturer’s “deficient corporate environmental policy”.

Primary insured J’s liability is triggered by each act of pollution. Therefore, each instance of pollution can be considered a separate event for the purposes of Article 5.2 paragraph (2). Having determined that each instance of pollution constitutes a separate event, it is necessary to move further back on the chain of causation in search of an aggregating cause that provoked each of these instances of pollution. It appears quite likely that not having in place an adequate corporate environmental policy would lead to the pollution of environmental sites. Therefore, the lack of a proper environmental policy can be considered a common cause for the purposes of Article 5.3 paragraph (2).

The final step is to determine whether each loss can be considered to be a direct consequence of the respective instance of pollution. Any losses that can be considered a direct consequence of any of these instances of pollution are to be aggregated under Article 5.3 paragraph (2) (cf. *Travelers Casualty and Surety v Certain Underwriters at Lloyd’s of London*, 96 NY2d 583 (2001) in which it was held that the pollution of over 150 waste sites did not constitute one single event).

4. Sublimits

- C24. Reinsurance contracts regularly not only contain coverage limits but also sublimits. Sublimits define a limit of liability with respect to a particular peril when the contract provides for coverage against a multitude of perils or with respect to a specific reinsured asset when reinsurance is taken out for a multitude of different assets or with respect to a specific location when the reinsured assets are located at a multitude of places.
- C25. Under the PRICL, aggregation is dealt with on each level of limits, i.e. total coverage limits, sublimits and sub-sublimits. The aggregation mechanism does not have to be identical on each level of limits.

Illustrations

- I12. Reinsured A takes out property reinsurance for a large number of buildings on an island against the perils of fire and tsunami. The contract provides for a total liability limit of USD 30 million for any losses originating in one cause. It further provides for sublimits of USD 20 million for losses arising from the peril of tsunami and USD 20 million for losses resulting from the peril of fire. An earthquake provokes a tsunami which hits the island's coast and causes losses in the amount of USD 20 million. At the same time, it provokes a short-circuit resulting in a fire which causes a loss totaling USD 30 million.

Two separate perils (fire and tsunami) materialize. Each materialization is to be considered a distinct event within the meaning of Article 5.2 paragraph (1). The sublimits clause refers to the materialization of a peril reinsured against. Thus, for the purpose of aggregation under the sublimits, an event-based aggregation according to Article 5.2 paragraph (1) applies. The tsunami losses of USD 20 million remain within the sublimit for tsunami losses. The fire losses of USD 30 million, however, exceed the sublimit for fire losses by USD 10 million. Hence, USD 10 million of the fire losses are not covered under the contract.

All the losses covered under the sublimits may then be aggregated under the total liability clause providing for a cause-based aggregation. Both fire losses and tsunami losses are caused by the earthquake. Therefore, the earthquake can be considered the unifying cause under Article 5.3 paragraph (1). Consequently, USD 20 million of tsunami losses are aggregated with USD 20 million (not USD 30 million) of fire losses. The aggregate of these losses amounts to USD 40 million, which exceeds the total liability limit by USD 10 million. Under this contract, USD 30 million of losses resulting from the unifying cause of earthquake are covered.

- I13. The contract provides that Reinsured B has taken out reinsurance for losses originating from one common cause in the amount of USD 11 million. It further provides for a sublimit of USD 10 million per occurrence for fire losses. For sexual assault losses, A is covered for up to USD 1 million per occurrence. At a Christmas party, director K negligently sets fire to his offices resulting in damage to the building worth USD 6 million. Later in the evening, K sexually

assaults an employee and thereby causes a loss in the amount of USD 5 million. Hence, the total loss amounts to USD 11 million. K was alcoholized during the entire evening.

K triggers his liability in two separate instances, i.e. upon negligently setting the fire and upon sexually assaulting an employee. Each liability triggering act is to be considered a distinct event within the meaning of Article 5.2 paragraph (2). The sublimits clauses refer to the liability triggering acts of setting fire and committing sexual assault. Thus, for the purpose of aggregation under the sublimits, an event-based aggregation according to Article 5.2 paragraph (2) applies. The fire losses of USD 6 million remain within the respective sublimit. The sexual assault losses of USD 5 million, however, exceed the respective sublimit by USD 4 million. Hence, USD 4 million of the sexual assault losses are not covered under the contract.

All the losses covered under the sublimits may then be aggregated under the total liability clause providing for a cause-based aggregation. Both fire losses and sexual assault losses are caused by K's inebriation. Therefore, K's inebriation can be considered the aggregating cause under Article 5.3 paragraph (2). Consequently, USD 6 million of fire losses are aggregated with USD 1 million (not USD 5 million) of sexual assault losses. The aggregate of these losses amounts to USD 7 million, which remains within the total limit liability of USD 11 million. Under this contract, USD 7 million of losses resulting from the unifying cause of inebriation are covered.

- C26. If the sublimits clause provides for a sublimit with regard to the losses that occurred to a specified reinsured asset and originated from one cause, then the parties agreed on cause-based aggregation for losses occurring to this asset and Article 5.3 paragraph (1) applies. Any losses covered with regard to this asset are then aggregated with other losses under the total limit of liability clause if they originated in the same cause.

Illustration

- I14. Reinsured A takes out property reinsurance for a large number of buildings on an island against the perils of tsunami and fire. The contract provides for a total liability limit of USD 60 million for any losses originating in one cause. It further provides for a sublimit of USD 20 million for damage that occurs to building X at the sea bank. An earthquake provokes a tsunami which hits the island's coast and causes losses amounting to USD 30 million. Furthermore, it causes tsunami losses in the amount of USD 15 million as well as a fire loss of USD 10 million to building X.

Two separate perils (fire and tsunami) materialize independently of one another. Each instance of materialization is to be considered a distinct event within the meaning of Article 5.2 paragraph (1). The sublimits clause refers to damage occurring to building X and originating in one cause. Thus, for the purpose of aggregation under the sublimits, a cause-based aggregation according to Article 5.3 paragraph (1) applies. Both the tsunami loss and the fire loss in building X originated in the earthquake and therefore aggregate.

This aggregate amounts to USD 25 million and exceeds the sublimit with regard to building X by USD 5 million. Hence, USD 5 million of losses to building X are not covered under the contract.

All the losses covered under the sublimit may then be aggregated with other losses under the total liability clause providing for a cause-based aggregation. Both losses to building X and other losses are caused by the earthquake. Therefore, the earthquake can be considered the unifying cause under Article 5.3 paragraph (1) with regard to the total limit of liability. Consequently, USD 30 million for further losses are aggregated with USD 20 million (not USD 25 million) for losses occurring to building X. The aggregate of these losses amounts to USD 50 million and is within the total liability limit of USD 60 million. Under this contract, USD 50 million of losses resulting from the unifying cause of earthquake are covered.

5. Treaty reinsurance

- C27. In the case of treaty reinsurance, a reinsured takes out reinsurance for a multitude of risks covered by multiple primary insurance policies (the portfolio) under a single contract.
- C28. A common cause may lead to one or more instances of materialized peril (Article 5.2 paragraph (1)) or multiple liability triggering acts, omissions or facts (Article 5.2 paragraph (2)), which in turn trigger a multitude of primary insurance policies within the portfolio. Under Article 5.3, these losses are treated as one single loss with regard to reinsurance retention (deductible) and coverage limit.

Illustrations

- I15. Reinsured A takes out reinsurance for a reinsurance portfolio of property insurance policies. The peril insured against is fire. An earthquake occurs and leads to 15 separate fires at different places. These different fires damage properties which were insured in a multitude of primary insurance policies, all figuring in the treaty reinsurance portfolio. The peril of fire materializes in 15 separate instances.

Each instance of materialization is to be considered a distinct event within the meaning of Article 5.2 paragraph (1). In the ordinary course of things, it appears quite likely that an earthquake may result in a fire. Therefore, under Article 5.3 paragraph (1), the earthquake is to be considered the aggregating cause. Consequently, any losses occurring as a direct consequence of any fires that originated from the earthquake are to be aggregated. The fact that the separate fire losses occurred under separate primary insurance policies does not conflict with the aggregation of losses under Article 5.3 paragraph (1).

- I16. Reinsured B takes out reinsurance for a portfolio of property car insurance policies. The peril insured against is damage or destruction. Due to an instance of heavy rainfalls in Germany, multiple accidents occur independently of one another.

The peril of damage or destruction materializes in multiple instances. Each instance of materialization is to be considered a distinct event for the purposes of Article 5.2 paragraph (1). In the ordinary course of things, it appears likely that heavy rainfalls may lead to the occurrence of a car accident and result in damage to or destruction of a car. Therefore, under Article 5.3 paragraph (1), the rainfalls are to be considered the unifying cause. Consequently, any losses that occurred as a direct consequence of any accident originating in the heavy rainfalls are to be aggregated. The fact that the separate losses occurred under separate primary insurance policies does not conflict with the aggregation of losses under Article 5.3 paragraph (1).

- I17. Reinsured C takes out reinsurance for a portfolio of property car insurance policies. The peril insured against is damage or destruction. Due to multiple instances of heavy rainfalls in Germany and Argentina, multiple accidents occur independently of one another.

The peril of damage or destruction materializes in multiple instances. Each instance of materialization is to be considered a distinct event for the purposes of Article 5.2 paragraph (1). In the ordinary course of things, it appears likely that heavy rainfalls may lead to the occurrence of a car accident and result in damage to or destruction of a car.

Under Article 5.3 paragraph (1), the rainfalls in Germany and the rainfalls in Argentina are each to be considered a separate unifying cause. Consequently, any of the individual losses resulting from the rainfalls in Germany are aggregated and any losses arising from the rainfalls in Argentina are aggregated.

By contrast, as the rainfalls in Germany and those in Argentina are to be considered separate unifying causes under Article 5.3 paragraph (1), the losses arising from the rainfalls in Germany are not to be aggregated with the losses resulting from the rainfalls in Argentina

- I18. Three primary insureds, D, E and F, all work for the same employer, G, who has taken out three separate professional indemnity insurance policies for his employees. Reinsured H takes out reinsurance for all three primary insurance policies under one contract. For lack of proper training, the three employees, independently of one another, trigger their liability by mis-selling pensions.

Each instance of mis-selling is to be considered a distinct event within the meaning of Article 5.2 paragraph (2). Having determined that each act of mis-selling constitutes a separate event, it is necessary to move further back on the chain of causation in search of an aggregating cause that provoked each of these underwritings. In the ordinary course of things, it appears quite likely that improper sales training would lead to the mis-selling of pensions. Therefore, under Article 5.3 paragraph (2), the employees' lack of training is to be considered the unifying common cause.

Any losses that occurred as a direct consequence of any of the acts of mis-selling are to be aggregated. The fact that the errors and omissions of each employee were insured under separate primary insurance policies does not conflict with the aggregation of all the losses under Article 5.3 paragraph (2) (cf. *Countrywide Assured Group Plc v Marshall* [2002] WL 31173646, 6).

6. Life insurance policies

C29. For the relevance of aggregating losses in life insurance, see Article 5.2 Comments C34 et seqq.

7. Bundled insurance products

C30. If a primary insurance policy contains aspects of first- and third-party insurance, it may be that an instance of materialized peril (first-party) and a liability triggering act, omission or fact (third-party) originated in the same cause. In such cases, losses under the first-party insurance are to be aggregated with losses under the third-party insurance.

Illustration

I19. A sole household insurance policy protects primary insured A against first- and third-party losses. After a house party, A – in an alcoholized condition – damages an expensive work of art which belongs to an artist and was displayed at the party. By negligently damaging the painting, A triggers his liability under the third-party aspect of the household insurance. This accident can be considered the event for the purposes of Article 5.2 paragraph (2). A few minutes later, A stumbles over his TV and damages it. Under the first-party aspect of the household insurance, the peril of damage by accident materialized when A stumbled over his TV. This accident can be said to be the event for the purposes of Article 5.2 paragraph (1). Having determined that damaging the work of art and damaging the TV are to be considered two separate events, it is necessary to move further back on the chain of causation in search of an aggregating cause that provoked each of the events.

In the ordinary course of things, it appears quite likely that an alcoholized person would damage goods belonging to himself or others. Therefore, under Article 5.3, A's condition of intoxication is to be regarded as the aggregating cause. Therefore, the loss associated with the art work and the loss associated with the TV are aggregated.

Appendix A

For the reader's convenience, appendix A reproduces the text of the Principles of Reinsurance Contract Law without Comments and Illustrations. It is to be recalled, however, that the PRICL are accompanied by official Comments and Illustrations.

Final Draft - subject to linguistic amendments

CHAPTER 1**General Provisions****SECTION 1: APPLICATION OF THE PRICL****ARTICLE 1.1.1**

(Substantive Scope of Application)

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

ARTICLE 1.1.2

(External Gaps)

Issues not settled by the PRICL shall be settled in accordance with the UNIDROIT Principles of International Commercial Contracts 2016 (“PICC”).

ARTICLE 1.1.3

(Exclusion or Modification of the PRICL)

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

ARTICLE 1.1.4

(Usages and Practices)

(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.

ARTICLE 1.1.5*(Mandatory Rules)*

Application of the PRICL shall not restrict the application of mandatory rules, whether of national, international or supranational origin, where applicable.

ARTICLE 1.1.6*(Interpretation and internal gaps)*

(1) In the interpretation of the PRICL, regard is to be had to their international character and to their purposes including the need to promote the observance of good faith and fair dealing in the reinsurance sector and uniformity in the application of the PRICL.

(2) Issues within the scope of the PRICL but not expressly settled by them are as far as possible to be settled in accordance with their underlying principles.

SECTION 2: DEFINITIONS**ARTICLE 1.2.1***(Reinsurance Contract)*

(1) "Contract of reinsurance" means a contract under which one party, the reinsurer, in consideration of a premium, promises another party, the reinsured, cover against the risk of exposure to insurance and/or reinsurance claims.

(2) Unless otherwise indicated, the term "contract" as used in the PRICL refers to a contract of reinsurance.

ARTICLE 1.2.2*(Further Definitions)*

[Note: to be drafted in the course of the project.]

CHAPTER 2

Duties of the Reinsurer and the Reinsured

SECTION 1: GENERAL DUTIES

ARTICLE 2.1.1

(Duties in general)

Throughout the negotiation, formation, operation, termination or avoidance of the contract, the parties owe one another the duties set forth in this Chapter.

ARTICLE 2.1.2

(Duty of utmost good faith)

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.

ARTICLE 2.1.3

(Confidentiality)

The parties shall treat information provided one another as confidential. Absent permission, they shall not disclose it to third parties except where required by law and except as necessary to provide information to professional advisers, statutory auditors, regulatory authorities and retrocessionaires.

ARTICLE 2.1.4

(Good faith in dispute resolution)

The parties shall make reasonable and diligent efforts to resolve disputes arising pursuant to the contract as expeditiously and efficiently as possible.

SECTION 2: PRECONTRACTUAL DUTY OF THE REINSURED

ARTICLE 2.2.1

(Duty of disclosure by prospective reinsured)

In seeking reinsurance cover, a prospective reinsured shall provide the reinsurer with all information of which it is or reasonably ought to be aware and which is material to the risks to be assumed by the reinsurer. Information is material to a risk if the information is of the type that would affect a reasonable and prudent reinsurer's decision as to whether to accept the risk and if so under which terms and conditions and for which premium.

SECTION 3: DUTIES OWED DURING THE CONTRACT PERIOD**ARTICLE 2.3.1**

(Premium payment)

(1) Premiums shall be paid by the reinsured in accordance with the terms of the contract. The reinsurer is required to demand payment in order to trigger the reinsured's payment obligation. Premiums shall be paid promptly after demand has been made.

(2) Where premium payment is late, i.e., after expiration of the period provided by Para. (1), the reinsurer is entitled to interest in accordance with Article 7.4.9 PICC.

ARTICLE 2.3.2

(Contract documentation)

The parties shall cooperate regarding documentation of any agreement and shall seek reasonably prompt documentation of the contract.

ARTICLE 2.3.3

(Notice of changed circumstances or increased risk)

The reinsured shall timely give notice of changed circumstances that a reasonable and prudent reinsurer would have regarded as material within the meaning of Article 2.2.1.

ARTICLE 2.3.4

(Reinsurer rights of inspection)

The reinsurer has the right to inspect the records of the reinsured concerning the insured relationship subject to giving reasonable advance notice. The reinsurer's request must be reasonable regarding time, place and manner of inspection.

SECTION 4: DUTIES OWED DURING THE CLAIMS PROCESS**ARTICLE 2.4.1**

(Claims handling by the reinsured)

The reinsured shall act reasonably and prudently when addressing claims by its insureds that may result in claims for reinsurance coverage.

ARTICLE 2.4.2

(Notice of claims)

The reinsured shall give the reinsurer adequate and timely notice of claims subject to the reinsurance contract and of circumstances that pose a significant chance of resulting in reinsurance coverage.

ARTICLE 2.4.3

(Follow-the-fortunes and follow-the-settlements)

The reinsurer shall follow the fortunes of the reinsured and follow the settlements of the reinsured by reimbursing the reinsured for payment of loss covered by the reinsurance contract and arguably covered by the primary insurance contract.

ARTICLE 2.4.4

(Cooperation in claims handling)

The parties shall reasonably cooperate regarding all aspects of the handling and administration of reinsurance claims.

ARTICLE 2.4.5

(Timely payment of reinsurance claims and resolution of disputes)

Upon proper presentation of a claim by the reinsured for payment, the reinsurer shall make reasonably prompt payment of amounts to be paid on a claim to the reinsured pursuant to the contract. The parties may specify the precise terms and timing of payments.

Chapter 3**REMEDIES****ARTICLE 3.1**

(Remedies for breach of contract)

- (1) If a party breaches the contract, an aggrieved party is entitled to claim
 - (a) performance in accordance with Chapter 7 Section 2 PICC;
 - (b) damages in accordance with Chapter 7 Section 4 PICC.
- (2) An aggrieved party may terminate the contract if it cannot reasonably be expected to uphold the contract.

ARTICLE 3.2

(Remedies for breach of pre-contractual duty of disclosure)

- (1) If the prospective reinsured breaches its duty of disclosure as set forth in Article 2.2.1 and if the reinsurer, had it known the undisclosed information, would have entered into the contract on different terms and conditions other than the premium, the reinsurer is entitled to retroactively adjust the contract to these different terms and conditions.
- (2) Subject to paragraph (1), if the prospective reinsured breaches its duty of disclosure as set forth in Article 2.2.1 and if the reinsurer, had it known the undisclosed information, would have entered into the contract on a higher premium, the reinsurer is entitled to

(a) proportionally reduce the amount to be paid on any claim arising from a loss that occurred before the reinsurer became aware of the breach and

(b) claim the higher premium for the remaining contract period while providing full coverage according to the adjusted contract for all claims arising from a loss that occurred after the reinsurer became aware of the breach.

If the reinsured notifies the reinsurer, within reasonable time after the adjustment, it is entitled to pay the higher premium retroactively to the formation of the contract and to full coverage for losses of which it was not aware prior to notification.

(3) A breach of the duty of disclosure as set forth in Article 2.2.1 by the prospective reinsured entitles the reinsurer to avoid the contract retroactively if

(a) the duty was breached fraudulently, or

(b) the reinsurer would not have entered into the contract at all had it known the undisclosed information.

If the reinsurer exercises a remedy pursuant to paragraphs (1) to (3), it may claim additional damages.

CHAPTER 4

Loss allocation

ARTICLE 4.1

(Scope of application)

This Chapter applies where the parties to the contract agree to allocate losses according to a “losses occurring” basis or “risks attaching” basis.

ARTICLE 4.2

(Losses occurring)

(1) An allocation clause referring to “losses occurring” brings within the temporal scope of the contract any obligation of the reinsured arising during the reinsurance period as a consequence of the materialization of a peril insured against under the reinsured relationship.

- (2) The point in time when the obligation of the reinsured arises is to be determined pursuant to the terms and conditions of the reinsured relationship and the law applicable thereto.

ARTICLE 4.3

(Risks attaching)

An allocation clause referring to “risks attaching” brings within the temporal scope of the contract any obligation of the reinsured arising as a consequence of the materialization of a peril insured against under a reinsured relationship incepting or being renewed during the reinsurance period.

CHAPTER 5

Loss Aggregation

ARTICLE 5.1

(Principle)

- (1) With regard to deductibles and limits, the parties may agree in the reinsurance contract to treat two or more separate losses allocated to the same reinsurance period as one single loss.
- (2) In particular, they may agree to treat two or more separate losses as one single loss based on an aggregation per event or an aggregation per cause.

ARTICLE 5.2

(Event-based Aggregation)

- (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.
- (2) Where the parties agree on an event-based aggregation in a contract reinsuring third-party liability insurance policies, all losses that occur as a direct consequence of the same act, omission or fact giving rise or allegedly giving rise to the primary insured's liability shall be considered as arising out of one event.

ARTICLE 5.3

(Cause-based aggregation)

(1) Where the parties agree on a cause-based aggregation in a contract reinsuring first-party insurance policies, all losses that occur as the direct consequence of one or multiple events within the meaning of Article 5.2 paragraph (1) shall be considered as arising out of one common cause if it was reasonably foreseeable that a cause of this kind could give rise to such an event.

(2) Where the parties agree on a cause-based aggregation in a contract reinsuring third-party insurance policies, all losses that occur as the direct consequence of one or multiple events within the meaning of Article 5.2 paragraph (2) shall be considered as arising out of one common cause if it was reasonably foreseeable that a cause of this kind could give rise to such an event.

Appendix B

For the reader's convenience, appendix B reproduces the text of the UNIDROIT Principles of International Commercial Contracts (PICC). It is to be noted that the PICC are accompanied by official Comments which form integral part of the Principles. A version reproducing both the provisions as well as the Comments is available under: <https://www.unidroit.org/instruments/commercial-contracts/unidroit-principles-2016> (accessed 18 March 2019).

PREAMBLE

(Purpose of the Principles)

These Principles set forth general rules for international commercial contracts. They shall be applied when the parties have agreed that their contract be governed by them.(*). They may be applied when the parties have agreed that their contract be governed by general principles of law, the *lex mercatoria* or the like. They may be applied when the parties have not chosen any law to govern their contract. They may be used to interpret or supplement international uniform law instruments. They may be used to interpret or supplement domestic law. They may serve as a model for national and international legislators.

CHAPTER 1**GENERAL PROVISIONS****ARTICLE 1.1**

(Freedom of contract)

The parties are free to enter into a contract and to determine its content.

ARTICLE 1.2

(No form required)

Nothing in these Principles requires a contract, statement or any other act to be made in or evidenced by a particular form. It may be proved by any means, including witnesses.

ARTICLE 1.3

(Binding character of contract)

A contract validly entered into is binding upon the parties. It can only be modified or terminated in accordance with its terms or by agreement or as otherwise provided in these Principles.

ARTICLE 1.4

(Mandatory rules)

Nothing in these Principles shall restrict the application of mandatory rules, whether of national, international or

supranational origin, which are applicable in accordance with the relevant rules of private international law.

ARTICLE 1.5

(Exclusion or modification by the parties)

The parties may exclude the application of these Principles or derogate from or vary the effect of any of their provisions, except as otherwise provided in the Principles.

ARTICLE 1.6

(Interpretation and supplementation of the Principles)

(1) In the interpretation of these Principles, regard is to be had to their international character and to their purposes including the need to promote uniformity in their application.

(2) Issues within the scope of these Principles but not expressly settled by them are as far as possible to be settled in accordance with their underlying general principles.

ARTICLE 1.7

(Good faith and fair dealing)

(1) Each party must act in accordance with good faith and fair dealing in international trade.

(2) The parties may not exclude or limit this duty.

(3) The parties may not exclude or limit this duty with good faith and fair dealing in

(4) The parties may not exclude or limit this duty.

ARTICLE 1.8

(Inconsistent behaviour)

A party cannot act inconsistently with an understanding it has caused the other party to have and upon which that other party reasonably has acted in reliance to its detriment.

ARTICLE 1.9*(Usages and practices)*

- (1) The parties are bound by any usage to which they have agreed and by any practices which they have established between themselves.
- (2) The parties are bound by a usage that is widely known to and regularly observed in international trade by parties in the particular trade concerned except where the application of such a usage would be unreasonable.

ARTICLE 1.10*(Notice)*

- (1) Where notice is required it may be given by any means appropriate to the circumstances.
- (2) A notice is effective when it reaches the person to whom it is given.
- (3) For the purpose of paragraph (2) a notice “reaches” a person when given to that person orally or delivered at that person’s place of business or mailing address.
- (4) For the purpose of this Article “notice” includes a declaration, demand, request or any other communication of intention.

ARTICLE 1.11*(Definitions)***In these Principles**

- “court” includes an arbitral tribunal;
- where a party has more than one place of business the relevant “place of business” is that which has the closest relationship to the contract and its performance, having regard to the circumstances known to or contemplated by the parties at any time before or at the conclusion of the contract;
- “long-term contract” refers to a contract which is to be performed over a period of time and which normally involves, to a varying degree, complexity of the transaction and an ongoing relationship between the parties;
- “obligor” refers to the party who is to perform an obligation and “obligee” refers to the party who is entitled to performance of that obligation;

– “writing” means any mode of communication that preserves a record of the information contained therein and is capable of being reproduced in tangible form.

ARTICLE 1.12

(Computation of time set by parties)

- (1) Official holidays or non-business days occurring during a period set by parties for an act to be performed are included in calculating the period.
- (2) However, if the last day of the period is an official holiday or a non-business day at the place of business of the party to perform the act, the period is extended until the first business day which follows, unless the circumstances indicate otherwise.
- (3) The relevant time zone is that of the place of business of the party setting the time, unless the circumstances indicate otherwise.

CHAPTER 2

FORMATION AND AUTHORITY OF AGENTS

SECTION 1: FORMATION

ARTICLE 2.1.1

(Manner of formation)

A contract may be concluded either by the acceptance of an offer or by conduct of the parties that is sufficient to show agreement.

ARTICLE 2.1.2

(Definition of offer)

A proposal for concluding a contract constitutes an offer if it is sufficiently definite and indicates the intention of the offeror to be bound in case of acceptance.

ARTICLE 2.1.3

(Withdrawal of offer)

- (1) An offer becomes effective when it reaches the offeree.

- (2) An offer, even if it is irrevocable, may be withdrawn if the withdrawal reaches the offeree before or at the same time as the offer.

ARTICLE 2.1.4

(Revocation of offer)

- (1) Until a contract is concluded an offer may be revoked if the revocation reaches the offeree before it has dispatched an acceptance.
- (2) However, an offer cannot be revoked
- (c) if it indicates, whether by stating a fixed time for acceptance or otherwise, that it is irrevocable; or
- (d) if it was reasonable for the offeree to rely on the offer as being irrevocable and the offeree has acted in reliance on the offer.

ARTICLE 2.1.5

(Rejection of offer)

An offer is terminated when a rejection reaches the offeror.

ARTICLE 2.1.6

(Mode of acceptance)

- (1) A statement made by or other conduct of the offeree indicating assent to an offer is an acceptance. Silence or inactivity does not in itself amount to acceptance.
- (2) An acceptance of an offer becomes effective when the indication of assent reaches the offeror.
- (3) However, if, by virtue of the offer or as a result of practices which the parties have established between themselves or of usage, the offeree may indicate assent by performing an act without notice to the offeror, the acceptance is effective when the act is performed.

ARTICLE 2.1.7*(Time of acceptance)*

An offer must be accepted within the time the offeror has fixed or, if no time is fixed, within a reasonable time having regard to the circumstances, including the rapidity of the means of communication employed by the offeror. An oral offer must be accepted immediately unless the circumstances indicate otherwise.

ARTICLE 2.1.8*(Acceptance within a fixed period of time)*

A period of acceptance fixed by the offeror begins to run from the time that the offer is dispatched. A time indicated in the offer is deemed to be the time of dispatch unless the circumstances indicate otherwise.

ARTICLE 2.1.9*(Late acceptance. Delay in transmission)*

(1) A late acceptance is nevertheless effective as an acceptance if without undue delay the offeror so informs the offeree or gives notice to that effect.

(2) If a communication containing a late acceptance shows that it has been sent in such circumstances that if its transmission had been normal it would have reached the offeror in due time, the late acceptance is effective as an acceptance unless, without undue delay, the offeror informs the offeree that it considers the offer as having lapsed.

ARTICLE 2.1.10*(Withdrawal of acceptance)*

An acceptance may be withdrawn if the withdrawal reaches the offeror before or at the same time as the acceptance would have become effective.

ARTICLE 2.1.11*(Modified acceptance)*

(1) A reply to an offer which purports to be an acceptance but contains additions, limitations or other modifications is a rejection of the offer and constitutes a counter-offer.

(2) However, a reply to an offer which purports to be an acceptance but contains additional or different terms which do not materially alter the terms of the offer constitutes an acceptance, unless the offeror, without undue delay, objects to the discrepancy. If the offeror does not object, the terms of the contract are the terms of the offer with the modifications contained in the acceptance.

ARTICLE 2.1.12

(Writings in confirmation)

If a writing which is sent within a reasonable time after the conclusion of the contract and which purports to be a confirmation of the contract contains additional or different terms, such terms become part of the contract, unless they materially alter the contract or the recipient, without undue delay, objects to the discrepancy.

ARTICLE 2.1.13

(Conclusion of contract dependent on agreement on specific matters or in a particular form)

Where in the course of negotiations one of the parties insists that the contract is not concluded until there is agreement on specific matters or in a particular form, no contract is concluded before agreement is reached on those matters or in that form.

ARTICLE 2.1.14

(Contract with terms deliberately left open)

(1) If the parties intend to conclude a contract, the fact that they intentionally leave a term to be agreed upon in further negotiations or to be determined by one of the parties or by a third person does not prevent a contract from coming into existence.

(2) The existence of the contract is not affected by the fact that subsequently

- (a) the parties reach no agreement on the term;
- (b) the party who is to determine the term does not do so; or
- (c) the third person does not determine the term, provided that there is an alternative means of rendering the term definite

that is reasonable in the circumstances, having regard to the intention of the parties.

ARTICLE 2.1.15

(Negotiations in bad faith)

- (1) A party is free to negotiate and is not liable for failure to reach an agreement.**
- (2) However, a party who negotiates or breaks off negotiations in bad faith is liable for the losses caused to the other party.**
- (3) It is bad faith, in particular, for a party to enter into or continue negotiations when intending not to reach an agreement with the other party.**

ARTICLE 2.1.16

(Duty of confidentiality)

Where information is given as confidential by one party in the course of negotiations, the other party is under a duty not to disclose that information or to use it improperly for its own purposes, whether or not a contract is subsequently concluded. Where appropriate, the remedy for breach of that duty may include compensation based on the benefit received by the other party.

ARTICLE 2.1.17

(Merger clauses)

A contract in writing which contains a clause indicating that the writing completely embodies the terms on which the parties have agreed cannot be contradicted or supplemented by evidence of prior statements or agreements. However, such statements or agreements may be used to interpret the writing.

ARTICLE 2.1.18

(Modification in a particular form)

A contract in writing which contains a clause requiring any modification or termination by agreement to be in a particular form may not be otherwise modified or terminated. However, a party may be precluded by its conduct from asserting such a clause to the extent that the other party has reasonably acted in reliance on that conduct.

ARTICLE 2.1.19

(Contracting under standard terms)

- (1) Where one party or both parties use standard terms in concluding a contract, the general rules on formation apply, subject to Articles 2.1.20 – 2.1.22.
- (2) Standard terms are provisions which are prepared in advance for general and repeated use by one party and which are actually used without negotiation with the other party.

ARTICLE 2.1.20

(Surprising terms)

- (1) No term contained in standard terms which is of such a character that the other party could not reasonably have expected it, is effective unless it has been expressly accepted by that party.
- (2) In determining whether a term is of such a character regard shall be had to its content, language and presentation.

ARTICLE 2.1.21

(Conflict between standard terms and non-standard terms)

In case of conflict between a standard term and a term which is not a standard term the latter prevails.

ARTICLE 2.1.22

(Battle of forms)

Where both parties use standard terms and reach agreement except on those terms, a contract is concluded on the basis of the agreed terms and of any standard terms which are common in substance unless one party clearly indicates in advance, or later and without undue delay informs the other party, that it does not intend to be bound by such a contract.

SECTION 2: AUTHORITY OF AGENTS

ARTICLE 2.2.1*(Scope of the Section)*

- (1) This Section governs the authority of a person (“the agent”) to affect the legal relations of another person (“the principal”) by or with respect to a contract with a third party, whether the agent acts in its own name or in that of the principal.**
- (2) It governs only the relations between the principal or the agent on the one hand, and the third party on the other.**
- (3) It does not govern an agent’s authority conferred by law or the authority of an agent appointed by a public or judicial authority.**

ARTICLE 2.2.2*(Establishment and scope of the authority of the agent)*

- (1) The principal’s grant of authority to an agent may be express or implied.**
- (2) The agent has authority to perform all acts necessary in the circumstances to achieve the purpose for which the authority was granted.**

ARTICLE 2.2.3*(Agency disclosed)*

- (1) Where an agent acts within the scope of its authority and the third party knew or ought to have known that the agent was acting as an agent, the acts of the agent shall directly affect the legal relations between the principal and the third party and no legal relation is created between the agent and the third party.**
- (2) However, the acts of the agent shall affect only the relations between the agent and the third party, where the agent with the consent of the principal undertakes to become the party to the contract.**

ARTICLE 2.2.4*(Agency undisclosed)*

- (1) Where an agent acts within the scope of its authority and the third party neither knew nor ought to have known that the agent was acting as an agent, the acts of the agent shall affect only the relations between the agent and the third party.**

(2) However, where such an agent, when contracting with the third party on behalf of a business, represents itself to be the owner of that business, the third party, upon discovery of the real owner of the business, may exercise also against the latter the rights it has against the agent.

ARTICLE 2.2.5

(Agent acting without or exceeding its authority)

(1) Where an agent acts without authority or exceeds its authority, its acts do not affect the legal relations between the principal and the third party.

(2) However, where the principal causes the third party reasonably to believe that the agent has authority to act on behalf of the principal and that the agent is acting within the scope of that authority, the principal may not invoke against the third party the lack of authority of the agent.

ARTICLE 2.2.6

(Liability of agent acting without or exceeding its authority)

(3) An agent that acts without authority or exceeds its authority is, failing ratification by the principal, liable for damages that will place the third party in the same position as if the agent had acted with authority and not exceeded its authority.

(4) However, the agent is not liable if the third party knew or ought to have known that the agent had no authority or was exceeding its authority.

ARTICLE 2.2.7

(Conflict of interests)

(1) If a contract concluded by an agent involves the agent in a conflict of interests with the principal of which the third party knew or ought to have known, the principal may avoid the contract. The right to avoid is subject to Articles 3.2.9 and 3.2.11 to 3.2.15.

(2) However, the principal may not avoid the contract

(a) if the principal had consented to, or knew or ought to have known of, the agent's involvement in the conflict of interests; or

- (b) if the agent had disclosed the conflict of interests to the principal and the latter had not objected within a reasonable time.

ARTICLE 2.2.8

(Sub-agency)

An agent has implied authority to appoint a sub-agent to perform acts which it is not reasonable to expect the agent to perform itself. The rules of this Section apply to the sub-agency.

ARTICLE 2.2.9

(Ratification)

- (1) An act by an agent that acts without authority or exceeds its authority may be ratified by the principal. On ratification the act produces the same effects as if it had initially been carried out with authority.
- (2) The third party may by notice to the principal specify a reasonable period of time for ratification. If the principal does not ratify within that period of time it can no longer do so.
- (3) If, at the time of the agent's act, the third party neither knew nor ought to have known of the lack of authority, it may, at any time before ratification, by notice to the principal indicate its refusal to become bound by a ratification.

ARTICLE 2.2.10

(Termination of authority)

- (1) Termination of authority is not effective in relation to the third party unless the third party knew or ought to have known of it.
- (2) Notwithstanding the termination of its authority, an agent remains authorised to perform the acts that are necessary to prevent harm to the principal's interests.

CHAPTER 3**VALIDITY****SECTION 1: GENERAL PROVISIONS****ARTICLE 3.1.1**

(Matters not covered)

This Chapter does not deal with lack of capacity.

ARTICLE 3.1.2

(Validity of mere agreement)

A contract is concluded, modified or terminated by the mere agreement of the parties, without any further requirement.

ARTICLE 3.1.3

(Initial impossibility)

(1) The mere fact that at the time of the conclusion of the contract the performance of the obligation assumed was impossible does not affect the validity of the contract.

(2) The mere fact that at the time of the conclusion of the contract a party was not entitled to dispose of the assets to which the contract relates does not affect the validity of the contract.

ARTICLE 3.1.4

(Mandatory character of the provisions)

The provisions on fraud, threat, gross disparity and illegality contained in this Chapter are mandatory.

SECTION 2: GROUNDS FOR AVOIDANCE**ARTICLE 3.2.1**

(Definition of mistake)

Mistake is an erroneous assumption relating to facts or to law existing when the contract was concluded.

ARTICLE 3.2.2*(Relevant mistake)*

(1) A party may only avoid the contract for mistake if, when the contract was concluded, the mistake was of such importance that a reasonable person in the same situation as the party in error would only have concluded the contract on materially different terms or would not have concluded it at all if the true state of affairs had been known, and

(a) the other party made the same mistake, or caused the mistake, or knew or ought to have known of the mistake and it was contrary to reasonable commercial standards of fair dealing to leave the mistaken party in error; or

(b) the other party had not at the time of avoidance reasonably acted in reliance on the contract.

(2) However, a party may not avoid the contract if

(a) it was grossly negligent in committing the mistake; or

(b) the mistake relates to a matter in regard to which the risk of mistake was assumed or, having regard to the circumstances, should be borne by the mistaken party.

ARTICLE 3.2.3*(Error in expression or transmission)*

An error occurring in the expression or transmission of a declaration is considered to be a mistake of the person from whom the declaration emanated.

ARTICLE 3.2.5*(Fraud)*

A party may avoid the contract when it has been led to conclude the contract by the other party's fraudulent representation, including language or practices, or fraudulent nondisclosure of circumstances which, according to reasonable commercial standards of fair dealing, the latter party should have disclosed.

ARTICLE 3.2.6*(Threat)*

A party may avoid the contract when it has been led to conclude the contract by the other party's unjustified threat which, having regard to the circumstances, is so imminent and serious as to leave the first party no reasonable alternative. In particular, a threat is unjustified if the act or omission with which a party has been threatened is wrongful in itself, or it is wrongful to use it as a means to obtain the conclusion of the contract.

ARTICLE 3.2.7*(Gross disparity)*

(1) A party may avoid the contract or an individual term of it if, at the time of the conclusion of the contract, the contract or term unjustifiably gave the other party an excessive advantage. Regard is to be had, among other factors, to

(a) the fact that the other party has taken unfair advantage of the first party's dependence, economic distress or urgent needs, or of its improvidence, ignorance, inexperience or lack of bargaining skill, and

(b) the nature and purpose of the contract.

(2) Upon the request of the party entitled to avoidance, a court may adapt the contract or term in order to make it accord with reasonable commercial standards of fair dealing.

(3) A court may also adapt the contract or term upon the request of the party receiving notice of avoidance, provided that that party informs the other party of its request promptly after receiving such notice and before the other party has reasonably acted in reliance on it. Article 3.2.10(2) applies accordingly.

ARTICLE 3.2.8*(Third persons)*

(1) Where fraud, threat, gross disparity or a party's mistake is imputable to, or is known or ought to be known by, a third person for whose acts the other party is responsible, the contract may be avoided under the same conditions as if the behaviour or knowledge had been that of the party itself.

(2) Where fraud, threat or gross disparity is imputable to a third person for whose acts the other party is not responsible, the contract may be avoided if that party knew or ought to have known of the fraud, threat or disparity, or has not at the time of avoidance reasonably acted in reliance on the contract.

ARTICLE 3.2.9

(Confirmation)

If the party entitled to avoid the contract expressly or impliedly confirms the contract after the period of time for giving notice of avoidance has begun to run, avoidance of the contract is excluded.

ARTICLE 3.2.10

(Loss of right to avoid)

(1) If a party is entitled to avoid the contract for mistake but the other party declares itself willing to perform or performs the contract as it was understood by the party entitled to avoidance, the contract is considered to have been concluded as the latter party understood it. The other party must make such a declaration or render such performance promptly after having been informed of the manner in which the party entitled to avoidance had understood the contract and before that party has reasonably acted in reliance on a notice of avoidance.

(2) After such a declaration or performance the right to avoidance is lost and any earlier notice of avoidance is ineffective.

ARTICLE 3.2.11

(Notice of avoidance)

The right of a party to avoid the contract is exercised by notice to the other party.

ARTICLE 3.2.12

(Time limits)

(1) Notice of avoidance shall be given within a reasonable time, having regard to the circumstances, after the avoiding party knew or could not have been unaware of the relevant facts or became capable of acting freely.

(2) Where an individual term of the contract may be avoided by a party under Article 3.2.7, the period of time for giving notice

of avoidance begins to run when that term is asserted by the other party.

ARTICLE 3.2.13

(Partial avoidance)

Where a ground of avoidance affects only individual terms of the contract, the effect of avoidance is limited to those terms unless, having regard to the circumstances, it is unreasonable to uphold the remaining contract.

ARTICLE 3.2.14

(Retroactive effect of avoidance)

Avoidance takes effect retroactively.

ARTICLE 3.2.15

(Restitution)

(1) On avoidance either party may claim restitution of whatever it has supplied under the contract, or the part of it avoided, provided that such party concurrently makes restitution of whatever it has received under the contract, or the part of it avoided.

(2) If restitution in kind is not possible or appropriate, an allowance has to be made in money whenever reasonable.

(3) The recipient of the performance does not have to make an allowance in money if the impossibility to make restitution in kind is attributable to the other party.

(4) Compensation may be claimed for expenses reasonably required to preserve or maintain the performance received.

ARTICLE 3.2.16

(Damages)

Irrespective of whether or not the contract has been avoided, the party who knew or ought to have known of the ground for avoidance is liable for damages so as to put the other party in the same position in which it would have been if it had not concluded the contract.

ARTICLE 3.2.17*(Unilateral declarations)*

The provisions of this Chapter apply with appropriate adaptations to any communication of intention addressed by one party to the other.

SECTION 3: ILLEGALITY**ARTICLE 3.3.1***(Contracts infringing mandatory rules)*

- (1) Where a contract infringes a mandatory rule, whether of national, international or supranational origin, applicable under Article 1.4 of these Principles, the effects of that infringement upon the contract are the effects, if any, expressly prescribed by that mandatory rule.
- (2) Where the mandatory rule does not expressly prescribe the effects of an infringement upon a contract, the parties have the right to exercise such remedies under the contract as in the circumstances are reasonable.
- (3) In determining what is reasonable regard is to be had in particular to:
 - (a) the purpose of the rule which has been infringed;
 - (b) the category of persons for whose protection the rule exists;
 - (c) any sanction that may be imposed under the rule infringed;
 - (d) the seriousness of the infringement;
 - (e) whether one or both parties knew or ought to have known of the infringement;
 - (f) whether the performance of the contract necessitates the infringement; and
 - (g) the parties' reasonable expectations.

ARTICLE 3.3.2*(Restitution)*

- (1) Where there has been performance under a contract infringing a mandatory rule under Article 3.3.1, restitution may be granted where this would be reasonable in the circumstances.
- (2) In determining what is reasonable, regard is to be had, with the appropriate adaptations, to the criteria referred to in Article 3.3.1(3).
- (3) If restitution is granted, the rules set out in Article 3.2.15 apply with appropriate adaptations.

CHAPTER 4**INTERPRETATION****ARTICLE 4.1***(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.

ARTICLE 4.2*(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.

ARTICLE 4.3*(Relevant circumstances)*

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.

ARTICLE 4.4*(Reference to contract or statement as a whole)*

Terms and expressions shall be interpreted in the light of the whole contract or statement in which they appear.

ARTICLE 4.5*(All terms to be given effect)*

Contract terms shall be interpreted so as to give effect to all the terms rather than to deprive some of them of effect.

ARTICLE 4.6*(Contra proferentem rule)*

If contract terms supplied by one party are unclear, an interpretation against that party is preferred.

ARTICLE 4.7*(Linguistic discrepancies)*

Where a contract is drawn up in two or more language versions which are equally authoritative there is, in case of discrepancy between the versions, a preference for the interpretation

according to a version in which the contract was originally drawn up.

ARTICLE 4.8

(Supplying an omitted term)

(1) Where the parties to a contract have not agreed with respect to a term which is important for a determination of their rights and duties, a term which is appropriate in the circumstances shall be supplied.

(2) In determining what is an appropriate term regard shall be had, among other factors, to

- (a) the intention of the parties;
- (b) the nature and purpose of the contract;
- (c) good faith and fair dealing;
- (d) reasonableness.

CHAPTER 5

CONTENT, THIRD PARTY RIGHTS AND CONDITIONS

SECTION 1: CONTENT

ARTICLE 5.1.1

(Express and implied obligations)

The contractual obligations of the parties may be express or implied.

ARTICLE 5.1.2

(Implied obligations)

Implied obligations stem from

- (e) the nature and purpose of the contract;
- (f) practices established between the parties and usages;
- (g) good faith and fair dealing;

- (h) reasonableness.

ARTICLE 5.1.3

(Co-operation between the parties)

Each party shall cooperate with the other party when such co-operation may reasonably be expected for the performance of that party's obligations.

ARTICLE 5.1.4

(Duty to achieve a specific result. Duty of best efforts)

- (1) To the extent that an obligation of a party involves a duty to achieve a specific result, that party is bound to achieve that result.
- (2) To the extent that an obligation of a party involves a duty of best efforts in the performance of an activity, that party is bound to make such efforts as would be made by a reasonable person of the same kind in the same circumstances.

ARTICLE 5.1.5

(Determination of kind of duty involved)

In determining the extent to which an obligation of a party involves a duty of best efforts in the performance of an activity or a duty to achieve a specific result, regard shall be had, among other factors, to

- (a) the way in which the obligation is expressed in the contract;
- (b) the contractual price and other terms of the contract;
- (c) the degree of risk normally involved in achieving the expected result;
- (d) the ability of the other party to influence the performance of the obligation.

ARTICLE 5.1.6

(Determination of quality of performance)

Where the quality of performance is neither fixed by, nor determinable from, the contract a party is bound to render a

performance of a quality that is reasonable and not less than average in the circumstances.

ARTICLE 5.1.7

(Price determination)

(1) Where a contract does not fix or make provision for determining the price, the parties are considered, in the absence of any indication to the contrary, to have made reference to the price generally charged at the time of the conclusion of the contract for such performance in comparable circumstances in the trade concerned or, if no such price is available, to a reasonable price.

(2) Where the price is to be determined by one party and that determination is manifestly unreasonable, a reasonable price shall be substituted notwithstanding any contract term to the contrary.

(3) Where the price is to be fixed by one party or a third person, and that party or third person does not do so, the price shall be a reasonable price.

(4) Where the price is to be fixed by reference to factors which do not exist or have ceased to exist or to be accessible, the nearest equivalent factor shall be treated as a substitute.

ARTICLE 5.1.8

(Termination of a contract for an indefinite period)

A contract for an indefinite period may be terminated by either party by giving notice a reasonable time in advance. As to the effects of termination in general, and as to restitution, the provisions in Articles 7.3.5 and 7.3.7 apply.

ARTICLE 5.1.9

(Release by agreement)

(1) An obligee may release its right by agreement with the obligor.

(2) An offer to release a right gratuitously shall be deemed accepted if the obligor does not reject the offer without delay after having become aware of it.

SECTION 2: THIRD PARTY RIGHTS

ARTICLE 5.2.1

(Contracts in favour of third parties)

(1) The parties (the “promisor” and the “promisee”) may confer by express or implied agreement a right on a third party (the “beneficiary”).

(2) The existence and content of the beneficiary’s right against the promisor are determined by the agreement of the parties and are subject to any conditions or other limitations under the agreement.

ARTICLE 5.2.2

(Third party identifiable)

The beneficiary must be identifiable with adequate certainty by the contract but need not be in existence at the time the contract is made.

ARTICLE 5.2.3

(Exclusion and limitation clauses)

The conferment of rights in the beneficiary includes the right to invoke a clause in the contract which excludes or limits the liability of the beneficiary.

ARTICLE 5.2.4

(Defences)

The promisor may assert against the beneficiary all defences which the promisor could assert against the promisee.

ARTICLE 5.2.5

(Revocation)

The parties may modify or revoke the rights conferred by the contract on the beneficiary until the beneficiary has accepted them or reasonably acted in reliance on them.

ARTICLE 5.2.6*(Renunciation)*

The beneficiary may renounce a right conferred on it.

SECTION 3: CONDITIONS**ARTICLE 5.3.1***(Types of condition)*

A contract or a contractual obligation may be made conditional upon the occurrence of a future uncertain event, so that the contract or the contractual obligation only takes effect if the event occurs (suspensive condition) or comes to an end if the event occurs (resolutive condition).

ARTICLE 5.3.2*(Effect of conditions)*

Unless the parties otherwise agree:

- (a) the relevant contract or contractual obligation takes effect upon fulfilment of a suspensive condition;
- (b) the relevant contract or contractual obligation comes to an end upon fulfilment of a resolutive condition.

ARTICLE 5.3.3*(Interference with conditions)*

- (1) If fulfilment of a condition is prevented by a party, contrary to the duty of good faith and fair dealing or the duty of co-operation, that party may not rely on the non-fulfilment of the condition.
- (2) If fulfilment of a condition is brought about by a party, contrary to the duty of good faith and fair dealing or the duty of co-operation, that party may not rely on the fulfilment of the condition.

ARTICLE 5.3.4

(Duty to preserve rights)

Pending fulfilment of a condition, a party may not, contrary to the duty to act in accordance with good faith and fair dealing, act so as to prejudice the other party's rights in case of fulfilment of the condition.

ARTICLE 5.3.5

(Restitution in case of fulfilment of a resolutive condition)

- (1) On fulfilment of a resolutive condition, the rules on restitution set out in Articles 7.3.6 and 7.3.7 apply with appropriate adaptations.
- (2) If the parties have agreed that the resolutive condition is to operate retroactively, the rules on restitution set out in Article 3.2.15 apply with appropriate adaptations.

CHAPTER 6**PERFORMANCE****SECTION 1: PERFORMANCE IN GENERAL****ARTICLE 6.1.1**

(Time of performance)

A party must perform its obligations:

- (a) if a time is fixed by or determinable from the contract, at that time;
- (b) if a period of time is fixed by or determinable from the contract, at any time within that period unless circumstances indicate that the other party is to choose a time;
- (c) in any other case, within a reasonable time after the conclusion of the contract.

ARTICLE 6.1.2

(Performance at one time or in instalments)

In cases under Article 6.1.1(b) or (c), a party must perform its obligations at one time if that performance can be rendered at one time and the circumstances do not indicate otherwise.

ARTICLE 6.1.3

(Partial performance)

(1) The obligee may reject an offer to perform in part at the time performance is due, whether or not such offer is coupled with an assurance as to the balance of the performance, unless the obligee has no legitimate interest in so doing.

(2) Additional expenses caused to the obligee by partial performance are to be borne by the obligor without prejudice to any other remedy.

ARTICLE 6.1.4

(Order of performance)

(1) To the extent that the performances of the parties can be rendered simultaneously, the parties are bound to render them simultaneously unless the circumstances indicate otherwise.

(2) To the extent that the performance of only one party requires a period of time, that party is bound to render its performance first, unless the circumstances indicate otherwise.

ARTICLE 6.1.5

(Earlier performance)

(1) The obligee may reject an earlier performance unless it has no legitimate interest in so doing.

(2) Acceptance by a party of an earlier performance does not affect the time for the performance of its own obligations if that time has been fixed irrespective of the performance of the other party's obligations.

(3) Additional expenses caused to the obligee by earlier performance are to be borne by the obligor, without prejudice to any other remedy.

ARTICLE 6.1.6*(Place of performance)*

- (1) If the place of performance is neither fixed by, nor determinable from, the contract, a party is to perform:
- (d) a monetary obligation, at the obligee's place of business;
 - (e) any other obligation, at its own place of business.
- (2) A party must bear any increase in the expenses incidental to performance which is caused by a change in its place of business subsequent to the conclusion of the contract.

ARTICLE 6.1.7*(Payment by cheque or other instrument)*

- (1) Payment may be made in any form used in the ordinary course of business at the place for payment.
- (2) However, an obligee who accepts, either by virtue of paragraph (1) or voluntarily, a cheque, any other order to pay or a promise to pay, is presumed to do so only on condition that it will be honoured.

ARTICLE 6.1.8*(Payment by funds transfer)*

- (1) Unless the obligee has indicated a particular account, payment may be made by a transfer to any of the financial institutions in which the obligee has made it known that it has an account.
- (2) In case of payment by a transfer the obligation of the obligor is discharged when the transfer to the obligee's financial institution becomes effective.

ARTICLE 6.1.9*(Currency of payment)*

- (1) If a monetary obligation is expressed in a currency other than that of the place for payment, it may be paid by the obligor in the currency of the place for payment unless
- (a) that currency is not freely convertible; or

(b) the parties have agreed that payment should be made only in the currency in which the monetary obligation is expressed.

(2) If it is impossible for the obligor to make payment in the currency in which the monetary obligation is expressed, the obligee may require payment in the currency of the place for payment, even in the case referred to in paragraph (1)(b).

(3) Payment in the currency of the place for payment is to be made according to the applicable rate of exchange prevailing there when payment is due.

(4) However, if the obligor has not paid at the time when payment is due, the obligee may require payment according to the applicable rate of exchange prevailing either when payment is due or at the time of actual payment.

ARTICLE 6.1.10

(Currency not expressed)

Where a monetary obligation is not expressed in a particular currency, payment must be made in the currency of the place where payment is to be made.

ARTICLE 6.1.11

(Costs of performance)

Each party shall bear the costs of performance of its obligations.

ARTICLE 6.1.12

(Imputation of payments)

(1) An obligor owing several monetary obligations to the same obligee may specify at the time of payment the debt to which it intends the payment to be applied. However, the payment discharges first any expenses, then interest due and finally the principal.

(2) If the obligor makes no such specification, the obligee may, within a reasonable time after payment, declare to the obligor the obligation to which it imputes the payment, provided that the obligation is due and undisputed.

(3) In the absence of imputation under paragraphs (1) or (2), payment is imputed to that obligation which satisfies one of the following criteria in the order indicated:

- (a) an obligation which is due or which is the first to fall due;**
- (b) the obligation for which the obligee has least security;**
- (c) the obligation which is the most burdensome for the obligor;**
- (d) the obligation which has arisen first. If none of the preceding criteria applies, payment is imputed to all the obligations proportionally.**

ARTICLE 6.1.13

(Imputation of non-monetary obligations)

Article 6.1.12 applies with appropriate adaptations to the imputation of performance of non-monetary obligations.

ARTICLE 6.1.14

(Application for public permission)

Where the law of a State requires a public permission affecting the validity of the contract or its performance and neither that law nor the circumstances indicate otherwise

- (a) if only one party has its place of business in that State, that party shall take the measures necessary to obtain the permission;**
- (b) in any other case the party whose performance requires permission shall take the necessary measures.**

ARTICLE 6.1.15

(Procedure in applying for permission)

- (1) The party required to take the measures necessary to obtain the permission shall do so without undue delay and shall bear any expenses incurred.**
- (2) That party shall whenever appropriate give the other party notice of the grant or refusal of such permission without undue delay.**

ARTICLE 6.1.16

(Permission neither granted nor refused)

(1) If, notwithstanding the fact that the party responsible has taken all measures required, permission is neither granted nor refused within an agreed period or, where no period has been agreed, within a reasonable time from the conclusion of the contract, either party is entitled to terminate the contract.

(2) Where the permission affects some terms only, paragraph (1) does not apply if, having regard to the circumstances, it is reasonable to uphold the remaining contract even if the permission is refused.

ARTICLE 6.1.17

(Permission refused)

(1) The refusal of a permission affecting the validity of the contract renders the contract void. If the refusal affects the validity of some terms only, only such terms are void if, having regard to the circumstances, it is reasonable to uphold the remaining contract.

(2) Where the refusal of a permission renders the performance of the contract impossible in whole or in part, the rules on non-performance apply.

SECTION 2: HARDSHIP**ARTICLE 6.2.1**

(Contract to be observed)

Where the performance of a contract becomes more onerous for one of the parties, that party is nevertheless bound to perform its obligations subject to the following provisions on hardship.

ARTICLE 6.2.2

(Definition of hardship)

There is hardship where the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party's performance has increased or because the value of the performance a party receives has diminished, and

- (a) the events occur or become known to the disadvantaged party after the conclusion of the contract;
- (b) the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract;
- (c) the events are beyond the control of the disadvantaged party; and
- (d) the risk of the events was not assumed by the disadvantaged party.

ARTICLE 6.2.3

(Effects of hardship)

- (1) In case of hardship the disadvantaged party is entitled to request renegotiations. The request shall be made without undue delay and shall indicate the grounds on which it is based.
- (2) The request for renegotiation does not in itself entitle the disadvantaged party to withhold performance.
- (3) Upon failure to reach agreement within a reasonable time either party may resort to the court.
- (4) If the court finds hardship it may, if reasonable,
 - (a) terminate the contract at a date and on terms to be fixed, or
 - (b) adapt the contract with a view to restoring its equilibrium.

CHAPTER 7

NON-PERFORMANCE

SECTION 1: NON-PERFORMANCE IN GENERAL

ARTICLE 7.1.1

(Non-performance defined)

Non-performance is failure by a party to perform any of its obligations under the contract, including defective performance or late performance.

ARTICLE 7.1.2*(Interference by the other party)*

A party may not rely on the non-performance of the other party to the extent that such non-performance was caused by the first party's act or omission or by another event for which the first party bears the risk.

ARTICLE 7.1.3*(Withholding performance)*

- (1) Where the parties are to perform simultaneously, either party may withhold performance until the other party tenders its performance.
- (2) Where the parties are to perform consecutively, the party that is to perform later may withhold its performance until the first party has performed.

ARTICLE 7.1.4*(Cure by non-performing party)*

- (1) The non-performing party may, at its own expense, cure any non-performance, provided that
 - (a) without undue delay, it gives notice indicating the proposed manner and timing of the cure;
 - (b) cure is appropriate in the circumstances;
 - (c) the aggrieved party has no legitimate interest in refusing cure; and
 - (d) cure is effected promptly.
- (2) The right to cure is not precluded by notice of termination.
- (3) Upon effective notice of cure, rights of the aggrieved party that are inconsistent with the non-performing party's performance are suspended until the time for cure has expired.
- (4) The aggrieved party may withhold performance pending cure.

(5) Notwithstanding cure, the aggrieved party retains the right to claim damages for delay as well as for any harm caused or not prevented by the cure.

ARTICLE 7.1.5

(Additional period for performance)

(1) In a case of non-performance the aggrieved party may by notice to the other party allow an additional period of time for performance.

(2) During the additional period the aggrieved party may withhold performance of its own reciprocal obligations and may claim damages but may not resort to any other remedy. If it receives notice from the other party that the latter will not perform within that period, or if upon expiry of that period due performance has not been made, the aggrieved party may resort to any of the remedies that may be available under this Chapter.

(3) Where in a case of delay in performance which is not fundamental the aggrieved party has given notice allowing an additional period of time of reasonable length, it may terminate the contract at the end of that period. If the additional period allowed is not of reasonable length it shall be extended to a reasonable length. The aggrieved party may in its notice provide that if the other party fails to perform within the period allowed by the notice the contract shall automatically terminate.

(4) Paragraph (3) does not apply where the obligation which has not been performed is only a minor part of the contractual obligation of the non-performing party.

ARTICLE 7.1.6

(Exemption clauses)

A clause which limits or excludes one party's liability for non-performance or which permits one party to render performance substantially different from what the other party reasonably expected may not be invoked if it would be grossly unfair to do so, having regard to the purpose of the contract.

ARTICLE 7.1.7

(Force majeure)

(1) Non-performance by a party is excused if that party proves that the non-performance was due to an impediment

beyond its control and that it could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences.

(2) When the impediment is only temporary, the excuse shall have effect for such period as is reasonable having regard to the effect of the impediment on the performance of the contract.

(3) The party who fails to perform must give notice to the other party of the impediment and its effect on its ability to perform. If the notice is not received by the other party within a reasonable time after the party who fails to perform knew or ought to have known of the impediment, it is liable for damages resulting from such non-receipt.

(4) Nothing in this Article prevents a party from exercising a right to terminate the contract or to withhold performance or request interest on money due.

SECTION 2: RIGHT TO PERFORMANCE

ARTICLE 7.2.1

(Performance of monetary obligation)

Where a party who is obliged to pay money does not do so, the other party may require payment.

ARTICLE 7.2.2

(Performance of non-monetary obligation)

Where a party who owes an obligation other than one to pay money does not perform, the other party may require performance, unless

- (a) performance is impossible in law or in fact;
- (b) performance or, where relevant, enforcement is unreasonably burdensome or expensive;
- (c) the party entitled to performance may reasonably obtain performance from another source;
- (d) performance is of an exclusively personal character; or

- (e) the party entitled to performance does not require performance within a reasonable time after it has, or ought to have, become aware of the non-performance.

ARTICLE 7.2.3

(Repair and replacement of defective performance)

The right to performance includes in appropriate cases the right to require repair, replacement, or other cure of defective performance. The provisions of Articles 7.2.1 and 7.2.2 apply accordingly.

ARTICLE 7.2.4

(Judicial penalty)

- (1) Where the court orders a party to perform, it may also direct that this party pay a penalty if it does not comply with the order.
- (2) The penalty shall be paid to the aggrieved party unless mandatory provisions of the law of the forum provide otherwise. Payment of the penalty to the aggrieved party does not exclude any claim for damages.

ARTICLE 7.2.5

(Change of remedy)

- (1) An aggrieved party who has required performance of a non-monetary obligation and who has not received performance within a period fixed or otherwise within a reasonable period of time may invoke any other remedy.
- (2) Where the decision of a court for performance of a non-monetary obligation cannot be enforced, the aggrieved party may invoke any other remedy.

ARTICLE 7.3.1

(Right to terminate the contract)

- (1) A party may terminate the contract where the failure of the other party to perform an obligation under the contract amounts to a fundamental non-performance.

(2) In determining whether a failure to perform an obligation amounts to a fundamental non performance regard shall be had, in particular, to whether

(a) the non-performance substantially deprives the aggrieved party of what it was entitled to expect under the contract unless the other party did not foresee and could not reasonably have foreseen such result;

(b) strict compliance with the obligation which has not been performed is of essence under the contract;

(c) the non-performance is intentional or reckless;

(d) the non-performance gives the aggrieved party reason to believe that it cannot rely on the other party's future performance;

(e) the non-performing party will suffer disproportionate loss as a result of the preparation or performance if the contract is terminated.

(3) In the case of delay the aggrieved party may also terminate the contract if the other party fails to perform before the time allowed it under Article 7.1.5 has expired.

ARTICLE 7.3.2

(Notice of termination)

(1) The right of a party to terminate the contract is exercised by notice to the other party.

(2) If performance has been offered late or otherwise does not conform to the contract the aggrieved party will lose its right to terminate the contract unless it gives notice to the other party within a reasonable time after it has or ought to have become aware of the offer or of the nonconforming performance.

ARTICLE 7.3.3

(Anticipatory non-performance)

Where prior to the date for performance by one of the parties it is clear that there will be a fundamental non-performance by that party, the other party may terminate the contract.

ARTICLE 7.3.4

(Adequate assurance of due performance)

A party who reasonably believes that there will be a fundamental non-performance by the other party may demand adequate assurance of due performance and may meanwhile withhold its own performance. Where this assurance is not provided within a reasonable time the party demanding it may terminate the contract.

ARTICLE 7.3.5

(Effects of termination in general)

- (1) Termination of the contract releases both parties from their obligation to effect and to receive future performance.
- (2) Termination does not preclude a claim for damages for non-performance.
- (3) Termination does not affect any provision in the contract for the settlement of disputes or any other term of the contract which is to operate even after termination.

ARTICLE 7.3.6

(Restitution with respect to contracts to be performed at one time)

- (1) On termination of a contract to be performed at one time either party may claim restitution of whatever it has supplied under the contract, provided that such party concurrently makes restitution of whatever it has received under the contract.
- (2) If restitution in kind is not possible or appropriate, an allowance has to be made in money whenever reasonable.
- (3) The recipient of the performance does not have to make an allowance in money if the impossibility to make restitution in kind is attributable to the other party.
- (4) Compensation may be claimed for expenses reasonably required to preserve or maintain the performance received.

ARTICLE 7.3.7

(Restitution with respect to long-term contracts)

- (1) On termination of a long-term contract restitution can only be claimed for the period after termination has taken effect, provided the contract is divisible.
- (2) As far as restitution has to be made, the provisions of Article 7.3.6 apply.

SECTION 4: DAMAGES**ARTICLE 7.4.1**

(Right to damages)

Any non-performance gives the aggrieved party a right to damages either exclusively or in conjunction with any other remedies except where the non-performance is excused under these Principles.

ARTICLE 7.4.2

(Full compensation)

- (1) The aggrieved party is entitled to full compensation for harm sustained as a result of the non-performance. Such harm includes both any loss which it suffered and any gain of which it
- (2) was deprived, taking into account any gain to the aggrieved party resulting from its avoidance of cost or harm.
- (3) Such harm may be non-pecuniary and includes, for instance, physical suffering or emotional distress.

ARTICLE 7.4.3

(Certainty of harm)

- (1) Compensation is due only for harm, including future harm, that is established with a reasonable degree of certainty.

Compensation may be due for the loss of a chance in proportion to the probability of its occurrence.

- (2) Where the amount of damages cannot be established with a sufficient degree of certainty, the assessment is at the discretion of the court.

ARTICLE 7.4.4

(Foreseeability of harm)

The non-performing party is liable only for harm which it foresaw or could reasonably have foreseen at the time of the conclusion of the contract as being likely to result from its nonperformance.

ARTICLE 7.4.5

(Proof of harm in case of replacement transaction)

Where the aggrieved party has terminated the contract and has made a replacement transaction within a reasonable time and in a reasonable manner it may recover the difference between the contract price and the price of the replacement transaction as well as damages for any further harm.

ARTICLE 7.4.6

(Proof of harm by current price)

- (1) Where the aggrieved party has terminated the contract and has not made a replacement transaction but there is a current price for the performance contracted for, it may recover the difference between the contract price and the price current at the time the contract is terminated as well as damages for any further harm.

- (2) Current price is the price generally charged for goods delivered or services rendered in comparable circumstances at the place where the contract should have been performed or, if there is no current price at that place, the current price at such other place that appears reasonable to take as a reference.

ARTICLE 7.4.7

(Harm due in part to aggrieved party)

Where the harm is due in part to an act or omission of the aggrieved party or to another event for which that party bears the risk, the amount of damages shall be reduced to the extent that these factors have contributed to the harm, having regard to the conduct of each of the parties.

ARTICLE 7.4.8*(Mitigation of harm)*

- (1) The non-performing party is not liable for harm suffered by the aggrieved party to the extent that the harm could have been reduced by the latter party's taking reasonable steps.
- (2) The aggrieved party is entitled to recover any expenses reasonably incurred in attempting to reduce the harm.

ARTICLE 7.4.9*(Interest for failure to pay money)*

- (1) If a party does not pay a sum of money when it falls due the aggrieved party is entitled to interest upon that sum from the time when payment is due to the time of payment whether or not the non-payment is excused.
- (2) The rate of interest shall be the average bank short-term lending rate to prime borrowers prevailing for the currency of payment at the place for payment, or where no such rate exists at that place, then the same rate in the State of the currency of payment. In the absence of such a rate at either place the rate of interest shall be the appropriate rate fixed by the law of the State of the currency of payment.
- (3) The aggrieved party is entitled to additional damages if the non-payment caused it a greater harm.

ARTICLE 7.4.10*(Interest on damages)*

Unless otherwise agreed, interest on damages for non-performance of non-monetary obligations accrues as from the time of nonperformance.

ARTICLE 7.4.11*(Manner of monetary redress)*

- (1) Damages are to be paid in a lump sum. However, they may be payable in instalments where the nature of the harm makes this appropriate.
- (2) Damages to be paid in instalments may be indexed.

ARTICLE 7.4.12

(Currency in which to assess damages)

Damages are to be assessed either in the currency in which the monetary obligation was expressed or in the currency in which the harm was suffered, whichever is more appropriate.

ARTICLE 7.4.13

(Agreed payment for non-performance)

(1) Where the contract provides that a party who does not perform is to pay a specified sum to the aggrieved party for such nonperformance, the aggrieved party is entitled to that sum irrespective of its actual harm.

(2) However, notwithstanding any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the harm resulting from the non-performance and to the other circumstances.

CHAPTER 8**SET-OFF****ARTICLE 8.1**

(Conditions of set-off)

(1) Where two parties owe each other money or other performances of the same kind, either of them ("the first party") may set off its obligation against that of its obligee ("the other party") if at the time of set-off,

- (a) the first party is entitled to perform its obligation;
- (b) the other party's obligation is ascertained as to its existence and amount and performance is due.

(2) If the obligations of both parties arise from the same contract, the first party may also set off its obligation against an obligation of the other party which is not ascertained as to its existence or to its amount.

ARTICLE 8.2*(Foreign currency set-off)*

Where the obligations are to pay money in different currencies, the right of set-off may be exercised, provided that both currencies are freely convertible and the parties have not agreed that the first party shall pay only in a specified currency.

ARTICLE 8.3*(Set-off by notice)*

The right of set-off is exercised by notice to the other party.

ARTICLE 8.4*(Content of notice)*

- (1) The notice must specify the obligations to which it relates.
- (2) If the notice does not specify the obligation against which set-off is exercised, the other party may, within a reasonable time, declare to the first party the obligation to which set-off relates. If no such declaration is made, the set-off will relate to all the obligations proportionally.

ARTICLE 8.5*(Effect of set-off)*

- (1) Set-off discharges the obligations.
- (2) If obligations differ in amount, set-off discharges the obligations up to the amount of the lesser obligation.
- (3) Set-off takes effect as from the time of notice.

CHAPTER 9**ASSIGNMENT OF RIGHTS, TRANSFER OF OBLIGATIONS, ASSIGNMENT OF CONTRACTS****SECTION 1: ASSIGNMENT OF RIGHTS**

ARTICLE 9.1.1*(Definitions)*

“Assignment of a right” means the transfer by agreement from one person (the “assignor”) to another person (the “assignee”), including transfer by way of security, of the assignor’s right to payment of a monetary sum or other performance from a third person (“the obligor”).

ARTICLE 9.1.2*(Exclusions)*

This Section does not apply to transfers made under the special rules governing the transfers:

- (a) of instruments such as negotiable instruments, documents of title or financial instruments, or**
- (b) of rights in the course of transferring a business.**

ARTICLE 9.1.3*(Assignability of non-monetary rights)*

A right to non-monetary performance may be assigned only if the assignment does not render the obligation significantly more burdensome.

ARTICLE 9.1.4*(Partial assignment)*

- (1) A right to the payment of a monetary sum may be assigned partially.**
- (2) A right to other performance may be assigned partially only if it is divisible, and the assignment does not render the obligation significantly more burdensome.**

ARTICLE 9.1.5*(Future rights)*

A future right is deemed to be transferred at the time of the agreement, provided the right, when it comes into existence, can be identified as the right to which the assignment relates.

ARTICLE 9.1.6

(Rights assigned without individual specification)

A number of rights may be assigned without individual specification, provided such rights can be identified as rights to which the assignment relates at the time of the assignment or when they come into existence.

ARTICLE 9.1.7

(Agreement between assignor and assignee sufficient)

(1) A right is assigned by mere agreement between the assignor and the assignee, without notice to the obligor.

(2) The consent of the obligor is not required unless the obligation in the circumstances is of an essentially personal character.

ARTICLE 9.1.8

(Obligor's additional costs)

The obligor has a right to be compensated by the assignor or the assignee for any additional costs caused by the assignment.

ARTICLE 9.1.9

(Non-assignment clauses)

(1) The assignment of a right to the payment of a monetary sum is effective notwithstanding an agreement between the assignor and the obligor limiting or prohibiting such an assignment. However, the assignor may be liable to the obligor for breach of contract.

(2) The assignment of a right to other performance is ineffective if it is contrary to an agreement between the assignor and the obligor limiting or prohibiting the assignment. Nevertheless, the assignment is effective if the assignee, at the time of the assignment, neither knew nor ought to have known of the agreement. The assignor may then be liable to the obligor for breach of contract.

ARTICLE 9.1.10*(Notice to the obligor)*

- (1) Until the obligor receives a notice of the assignment from either the assignor or the assignee, it is discharged by paying the assignor.
- (2) After the obligor receives such a notice, it is discharged only by paying the assignee.

ARTICLE 9.1.11*(Successive assignments)*

If the same right has been assigned by the same assignor to two or more successive assignees, the obligor is discharged by paying according to the order in which the notices were received.

ARTICLE 9.1.12*(Adequate proof of assignment)*

- (1) If notice of the assignment is given by the assignee, the obligor may request the assignee to provide within a reasonable time adequate proof that the assignment has been made.
- (2) Until adequate proof is provided, the obligor may withhold payment.
- (3) Unless adequate proof is provided, notice is not effective.
- (4) Adequate proof includes, but is not limited to, any writing emanating from the assignor and indicating that the assignment has taken place.

ARTICLE 9.1.13*(Defences and rights of set-off)*

- (1) The obligor may assert against the assignee all defences that the obligor could assert against the assignor.
- (2) The obligor may exercise against the assignee any right of set-off available to the obligor against the assignor up to the time notice of assignment was received.

ARTICLE 9.1.14

(Rights related to the right assigned)

The assignment of a right transfers to the assignee:

- (a) all the assignor's rights to payment or other performance under the contract in respect of the right assigned, and**
- (b) all rights securing performance of the right assigned.**

ARTICLE 9.1.15

(Undertakings of the assignor)

The assignor undertakes towards the assignee, except as otherwise disclosed to the assignee, that:

- (a) the assigned right exists at the time of the assignment, unless the right is a future right;**
- (b) the assignor is entitled to assign the right;**
- (c) the right has not been previously assigned to another assignee, and it is free from any right or claim from a third party;**
- (d) the obligor does not have any defences;**
- (e) neither the obligor nor the assignor has given notice of set-off concerning the assigned right and will not give any such notice;**
- (f) the assignor will reimburse the assignee for any payment received from the obligor before notice of the assignment was given.**

SECTION 2: TRANSFER OF OBLIGATIONS**ARTICLE 9.2.1**

(Modes of transfer)

An obligation to pay money or render other performance may be transferred from one person (the "original obligor") to another person (the "new obligor") either

- (a) by an agreement between the original obligor and the new obligor subject to Article 9.2.3, or**

- (b) by an agreement between the obligee and the new obligor, by which the new obligor assumes the obligation.

ARTICLE 9.2.2

(Exclusion)

This Section does not apply to transfers of obligations made under the special rules governing transfers of obligations in the course of transferring a business.

ARTICLE 9.2.3

(Requirement of obligee's consent to transfer)

The transfer of an obligation by an agreement between the original obligor and the new obligor requires the consent of the obligee.

ARTICLE 9.2.4

(Advance consent of obligee)

- (1) The obligee may give its consent in advance.**
- (2) If the obligee has given its consent in advance, the transfer of the obligation becomes effective when a notice of the transfer is given to the obligee or when the obligee acknowledges it.**

ARTICLE 9.2.5

(Discharge of original obligor)

- (1) The obligee may discharge the original obligor.**
- (2) The obligee may also retain the original obligor as an obligor in case the new obligor does not perform properly.**
- (3) Otherwise the original obligor and the new obligor are jointly and severally liable.**

ARTICLE 9.2.6

(Third party performance)

- (1) Without the obligee's consent, the obligor may contract with another person that this person will perform the obligation in place of the obligor, unless the obligation in the circumstances has an essentially personal character.**

- (2) The obligee retains its claim against the obligor.

ARTICLE 9.2.7

(Defences and rights of set-off)

- (1) The new obligor may assert against the obligee all defences which the original obligor could assert against the obligee.
- (2) The new obligor may not exercise against the obligee any right of set-off available to the original obligor against the obligee.

ARTICLE 9.2.8

(Rights related to the obligation transferred)

- (1) The obligee may assert against the new obligor all its rights to payment or other performance under the contract in respect of the obligation transferred.
- (2) If the original obligor is discharged under Article 9.2.5(1), a security granted by any person other than the new obligor for the performance of the obligation is discharged, unless that other person agrees that it should continue to be available to the obligee.
- (3) Discharge of the original obligor also extends to any security of the original obligor given to the obligee for the performance of the obligation, unless the security is over an asset which is transferred as part of a transaction between the original obligor and the new obligor.

SECTION 3: ASSIGNMENT OF CONTRACTS

ARTICLE 9.3.1

(Definitions)

“Assignment of a contract” means the transfer by agreement from one person (the “assignor”) to another person (the “assignee”) of the assignor’s rights and obligations arising out of a contract with another person (the “other party”).

ARTICLE 9.3.2*(Exclusion)*

This Section does not apply to the assignment of contracts made under the special rules governing transfers of contracts in the course of transferring a business.

ARTICLE 9.3.3*(Requirement of consent of the other party)*

The assignment of a contract requires the consent of the other party.

ARTICLE 9.3.4*(Advance consent of the other party)*

- (1) The other party may give its consent in advance.**
- (2) If the other party has given its consent in advance, the assignment of the contract becomes effective when a notice of the assignment is given to the other party or when the other party acknowledges it.**

ARTICLE 9.3.5*(Discharge of the assignor)*

- (1) The other party may discharge the assignor.**
- (2) The other party may also retain the assignor as an obligor in case the assignee does not perform properly.**
- (3) Otherwise the assignor and the assignee are jointly and severally liable.**

ARTICLE 9.3.6*(Defences and rights of set-off)*

- (1) To the extent that the assignment of a contract involves an assignment of rights, Article 9.1.13 applies accordingly.**
- (2) To the extent that the assignment of a contract involves a transfer of obligations, Article 9.2.7 applies accordingly.**

ARTICLE 9.3.7

(Rights transferred with the contract)

- (1) To the extent that the assignment of a contract involves an assignment of rights, Article 9.1.14 applies accordingly.
- (2) To the extent that the assignment of a contract involves a transfer of obligations, Article 9.2.8 applies accordingly.

CHAPTER 10**LIMITATION PERIODS****ARTICLE 10.1**

(Scope of the Chapter)

- (1) The exercise of rights governed by the Principles is barred by the expiration of a period of time, referred to as “limitation period”, according to the rules of this Chapter.
- (2) This Chapter does not govern the time within which one party is required under the Principles, as a condition for the acquisition or exercise of its right, to give notice to the other party or to perform any act other than the institution of legal proceedings.

ARTICLE 10.2

(Limitation periods)

- (1) The general limitation period is three years beginning on the day after the day the obligee knows or ought to know the facts as a result of which the obligee’s right can be exercised.
- (2) In any event, the maximum limitation period is ten years beginning on the day after the day the right can be exercised.

ARTICLE 10.3

(Modification of limitation periods by the parties)

- (1) The parties may modify the limitation periods.
- (2) However they may not
 - (a) shorten the general limitation period to less than one year;

- (b) shorten the maximum limitation period to less than four years;
- (c) extend the maximum limitation period to more than fifteen years.

ARTICLE 10.4

(New limitation period by acknowledgement)

- (1) Where the obligor before the expiration of the general limitation period acknowledges the right of the obligee, a new general limitation period begins on the day after the day of the acknowledgement.
- (2) The maximum limitation period does not begin to run again, but may be exceeded by the beginning of a new general limitation period under Article 10.2(1).

ARTICLE 10.5

(Suspension by judicial proceedings)

- (1) The running of the limitation period is suspended
 - (a) when the obligee performs any act, by commencing judicial proceedings or in judicial proceedings already instituted, that is recognised by the law of the court as asserting the obligee's right against the obligor;
 - (b) in the case of the obligor's insolvency when the obligee has asserted its rights in the insolvency proceedings; or
 - (c) in the case of proceedings for dissolution of the entity which is the obligor when the obligee has asserted its rights in the dissolution proceedings.
- (2) Suspension lasts until a final decision has been issued or until the proceedings have been otherwise terminated.

ARTICLE 10.6

(Suspension by arbitral proceedings)

- (1) The running of the limitation period is suspended when the obligee performs any act, by commencing arbitral proceedings or in arbitral proceedings already instituted, that is recognised by the law of the arbitral tribunal as asserting the obligee's right against the obligor. In the absence of regulations for arbitral

proceedings or provisions determining the exact date of the commencement of arbitral proceedings, the proceedings are deemed to commence on the date on which a request that the right in dispute should be adjudicated reaches the obligor.

(2) Suspension lasts until a binding decision has been issued or until the proceedings have been otherwise terminated.

ARTICLE 10.7

(Alternative dispute resolution)

The provisions of Articles 10.5 and 10.6 apply with appropriate modifications to other proceedings whereby the parties request a third person to assist them in their attempt to reach an amicable settlement of their dispute.

ARTICLE 10.8

(Suspension in case of force majeure, death or incapacity)

(1) Where the obligee has been prevented by an impediment that is beyond its control and that it could neither avoid nor overcome, from causing a limitation period to cease to run under the preceding Articles, the general limitation period is suspended so as not to expire before one year after the relevant impediment has ceased to exist.

(2) Where the impediment consists of the incapacity or death of the obligee or obligor, suspension ceases when a representative for the incapacitated or deceased party or its estate has been appointed or a successor has inherited the respective party's position. The additional oneyear period under paragraph (1) applies accordingly.

ARTICLE 10.9

(Effects of expiration of limitation period)

(1) The expiration of the limitation period does not extinguish the right.

(2) For the expiration of the limitation period to have effect, the obligor must assert it as a defence.

(3) A right may still be relied on as a defence even though the expiration of the limitation period for that right has been asserted.

ARTICLE 10.10*(Right of set-off)*

The obligee may exercise the right of set-off until the obligor has asserted the expiration of the limitation period.

ARTICLE 10.11*(Restitution)*

Where there has been performance in order to discharge an obligation, there is no right of restitution merely because the limitation period has expired.

CHAPTER 11**PLURALITY OF OBLIGORS AND OF OBLIGEEES****SECTION 1: PLURALITY OF OBLIGORS****ARTICLE 11.1.1***(Definitions)*

When several obligors are bound by the same obligation towards an obligee:

- (a) the obligations are joint and several when each obligor is bound for the whole obligation;
- (b) the obligations are separate when each obligor is bound only for its share.

ARTICLE 11.1.2*(Presumption of joint and several obligations)*

When several obligors are bound by the same obligation towards an obligee, they are presumed to be jointly and severally bound, unless the circumstances indicate otherwise.

ARTICLE 11.1.3

(Obligee's rights against joint and several obligors)

When obligors are jointly and severally bound, the obligee may require performance from any one of them, until full performance has been received.

ARTICLE 11.1.4

(Availability of defences and rights of set-off)

A joint and several obligor against whom a claim is made by the obligee may assert all the defences and rights of set-off that are personal to it or that are common to all the co-obligors, but may not assert defences or rights of set-off that are personal to one or several of the other coobligors.

ARTICLE 11.1.5

(Effect of performance or set-off)

Performance or set-off by a joint and several obligor or set-off by the obligee against one joint and several obligor discharges the other obligors in relation to the obligee to the extent of the performance or set-off.

ARTICLE 11.1.6

(Effect of release or settlement)

(1) Release of one joint and several obligor, or settlement with one joint and several obligor, discharges all the other obligors for the share of the released or settling obligor, unless the circumstances indicate otherwise.

(2) When the other obligors are discharged for the share of the released obligor, they no longer have a contributory claim against the released obligor under Article 11.1.10.

ARTICLE 11.1.7

(Effect of expiration or suspension of limitation period)

(1) Expiration of the limitation period of the obligee's rights against one joint and several obligor does not affect:

- (a) the obligations to the obligee of the other joint and several obligors; or
 - (b) the rights of recourse between the joint and several obligors under Article 11.1.10.
- (2) If the obligee initiates proceedings under Articles 10.5, 10.6 or 10.7 against one joint and several obligor, the running of the limitation period is also suspended against the other joint and several obligors.

ARTICLE 11.1.8

(Effect of judgment)

- (1) A decision by a court as to the liability to the obligee of one joint and several obligor does not affect:
- (a) the obligations to the obligee of the other joint and several obligors; or
 - (b) the rights of recourse between the joint and several obligors under Article 11.1.10.
- (2) However, the other joint and several obligors may rely on such a decision, except if it was based on grounds personal to the obligor concerned. In such a case, the rights of recourse between the joint and several obligors under Article 11.1.10 are affected accordingly.

ARTICLE 11.1.9

(Apportionment among joint and several obligors)

As among themselves, joint and several obligors are bound in equal shares, unless the circumstances indicate otherwise.

ARTICLE 11.1.10

(Extent of contributory claim)

A joint and several obligor who has performed more than its share may claim the excess from any of the other obligors to the extent of each obligor's unperformed share.

ARTICLE 11.1.11*(Rights of the obligee)*

(1) A joint and several obligor to whom Article 11.1.10 applies may also exercise the rights of the obligee, including all rights securing their performance, to recover the excess from all or any of the other obligors to the extent of each obligor's unperformed share.

(2) An obligee who has not received full performance retains its rights against the coobligors to the extent of the unperformed part, with precedence over co-obligors exercising contributory claims.

ARTICLE 11.1.12*(Defences in contributory claims)*

A joint and several obligor against whom a claim is made by the co-obligor who has performed the obligation:

- (a) may raise any common defences and rights of set-off that were available to be asserted by the co-obligor against the obligee;
- (b) may assert defences which are personal to itself ;
- (c) may not assert defences and rights of set-off which are personal to one or several of the other co-obligors.

ARTICLE 11.1.13*(Inability to recover)*

If a joint and several obligor who has performed more than that obligor's share is unable, despite all reasonable efforts, to recover contribution from another joint and several obligor, the share of the others, including the one who has performed, is increased proportionally.

SECTION 2: PLURALITY OF OBLIGEEES**ARTICLE 11.2.1***(Definitions)*

When several obligees can claim performance of the same obligation from an obligor:

- (a) the claims are separate when each obligee can only claim its share;
- (b) the claims are joint and several when each obligee can claim the whole performance;
- (c) the claims are joint when all obliges have to claim performance together.

ARTICLE 11.2.2

(Effects of joint and several claims)

Full performance of an obligation in favour of one of the joint and several obligees discharges the obligor towards the other obligees.

ARTICLE 11.2.3

(Availability of defences against joint and several obligees)

- (1) The obligor may assert against any of the joint and several obligees all the defences and rights of set-off that are personal to its relationship to that obligee or that it can assert against all the co-obligees, but may not assert defences and rights of set-off that are personal to its relationship to one or several of the other coobligees.
- (2) The provisions of Articles 11.1.5, 11.1.6, 11.1.7 and 11.1.8 apply, with appropriate adaptations, to joint and several claims.

ARTICLE 11.2.4

(Allocation between joint and several obligees)

- (1) As among themselves, joint and several obligees are entitled to equal shares, unless the circumstances indicate otherwise.
- (2) An obligee who has received more than its share must transfer the excess to the other obligees to the extent of their respective shares.

Appendix C

Appendix C affords sample Non-Disclosure-Agreements agreements and Inspection of Records Clauses used in the reinsurance market. The following examples of language is not intended to establish a rigid unitary template for all transactions. On the contrary, reinsurers and reinsureds have ample authority and ability to craft these agreements specific to and appropriate for their transactions and business relationship. The following examples are presented only as illustrations that are neither comprehensive nor mandatory.

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Sample Non-Disclosure/Confidentiality Language**Example One**

Reinsurer and Reinsured undertake to regard the transactions hereunder, as well as this Agreement, as strictly confidential and further declare and agree that they or their representatives will not at any time make use, either directly or indirectly, of the information provided due to agreements between the Reinsurer and the Reinsured except to the extent that such use is for the purpose of the Reinsurer conducting its ordinary business purposes.

Notwithstanding the above, it is noted and agreed that there may be occasions when information may be required to be provided to third parties such as legal counsel, arbitrators, auditors, governing bodies and regulatory bodies. Reinsurer and Reinsured shall not be precluded from providing such information where disclosure is compelled by such a requirement.

Example Two

The parties agree that all conditions and all renewal information contained in or related to this Reinsurance Agreement shall be considered confidential (hereinafter referred to as "the Confidential Information").

Not subject to confidentiality is information, which is public or already known at the time of disclosure or rightfully obtained from other sources or developed independently by the Reinsurer.

Notwithstanding the foregoing the Reinsurer shall be permitted to disclose the Confidential Information to its parent company, subsidiaries, affiliates, employees, agents, subcontractors, representatives, consultants, legal advisors, retrocessionaires, third party service providers and auditors.

However, the Reinsurer shall make its reasonable best efforts to ensure that the above will be fully informed of the content of this clause and that they will comply with the terms thereof. Nothing herein shall prohibit the Reinsurer from disclosing the Confidential Information if required by a court or by applicable law or regulations.

Example Three (Modestly Detailed and Specific Confidentiality Clause)

Any information exchanged or published by any party during negotiations preceding the conclusion of this agreement, as well as all information exchanged or published by a party during or after the conclusion of this agreement, is confidential in nature.

1. Each party (“the receiving party”) shall treat and hold as secret and confidential information which it may receive from the other party (“the disclosing party”) or which becomes known to it during the course of this agreement.
2. The receiving party undertakes and agrees that in order to protect the proprietary interests of disclosing party in and to its confidential information:
3. The receiving party will restrict the dissemination of the confidential information of the disclosing party to only those of its personnel, agents, contractors or other persons who are actively involved in the provision and acquisition of solution and services under this agreement and then only on a “need to know” basis and the receiving party will initiate internal security procedures reasonably acceptable to the disclosing party to prevent unauthorized disclosure and will take all practical steps to impress upon those persons who need to be given access to confidential information, the secret and confidential nature thereof.
4. The receiving party will not at any time during the currency of this agreement, either use any confidential information of the disclosing party or directly or indirectly divulge or disclose any confidential information of the disclosing party to third parties;
 - a. All written instructions, drawings, notes, memoranda and records of whatever nature relating to the confidential information of the disclosing party which have or will come into the possession of the receiving party and its personnel, will be and will at all times remain the sole and absolute property of the disclosing party and shall be promptly surrendered to the disclosing party upon the expiry of this agreement.
 - b. The foregoing shall not apply to any information that:
 - i. is lawfully in the public domain at the time of disclosure to the receiving party;
 - ii. subsequently becomes lawfully part of the public domain by publication or otherwise;

- iii. subsequently becomes available to the receiving party from a source other than the disclosing party which is lawfully entitled without any restriction on disclosure to disclose such confidential information to the receiving party; or
 - iv. is disclosed pursuant to a requirement or request by operation of law, regulation or court order or is required for ordinary business purposes of a contracting party and is not disseminated beyond the contracting party.
5. This clause is severable from the rest of this agreement and shall remain valid and binding irrespective of the termination or cancellation of this agreement for whatever reason.
6. The insurer shall conclude a confidentiality agreement with all cedents/insureds it contracts with to ensure the utmost confidentiality of a party's information.

Example Four (Confidentiality Definition and Specifications)(Does Not Include Language Regarding the Scope of Restrictions on Use of Such Information

Definitions.

As used in this Agreement:

The term "Confidential information" means any information, including but not limited to: a scientific discovery, data or information; technical, non-technical or financial data; a formula; a pattern; a compilation; a customer, supplier, or other list; a computer program or software; an equipment configuration; a method, practice or procedure; a technique; drawing or plan; or a process that is sufficiently confidential or secret to derive economic value, actual or potential, from not being generally known, and is subject to reasonable efforts by the receiving party to maintain its secrecy, under the circumstances.

By way of example, Confidential information could include, but is not limited to:

- scientific and technical findings and knowledge whether reduced to writing or not;
- business records
- correspondence
- marketing, advertising, and sales plans
- customer lists
- practices and procedures
- equipment design and configurations
- cost information

- data and documents in any format including electronic format
- copies
- intellectual property
- know-how,
- training material
- work materials
- and other information or data that is not generally known and the disclosure of which would cause competitive, or financial harm, or which would be an unauthorized invasion of the disclosing party's privacy.

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Sample Inspection of Records Language

Example One

Provided the Reinsured has received reasonable prior notice, the Reinsurer or its designated representative(s) shall have the right to inspect, at any reasonable time, all records of the Company that pertain in any way to this Contract.

Example Two

1. "Upon request the Reinsured shall make available to the Reinsurer or its duly authorized representatives at the Reinsured's head office or at any other place it may be located all information relating to the business reinsured under this Agreement in the Reinsured's possession or under its control.
2. The Reinsurer may exercise its right of inspection at any reasonable time. Notification of such visits shall be given at least two weeks and, in urgent cases, at least forty-eight hours in advance.
3. Upon request the Reinsured shall provide the Reinsurer with copies, to be made at the Reinsurer's expense, of any of the books, accounts or other documents containing information relating to the business reinsured under this Agreement.
4. Should arbitration or judicial proceedings be pending or initiated between the parties, the Reinsurer shall exercise its right of inspection through a person designated and authorized by the respective arbitrator or judge."

Example Three (emphasizing work product privilege)

The Reinsurer shall have the right to examine, at any reasonable time during the continuance of this Contract or of any liability hereunder, at the Head Office of the Company, all books and documents relating to business transacted under this Contract.

Notwithstanding the foregoing, the Reinsurer shall not have any right of access to the records of the Company if it is not current in all undisputed payments due the Company. Undisputed as used herein shall mean any claim that the Reinsurer has not contested in writing to the Company that specifies the reason(s) why the payments are disputed.

It is understood and agreed, however, that the business of the Company in which the Reinsurer has a reinsurance interest hereunder is the sole and absolute property of the Company and the Reinsurer agrees not to use any information

acquired by virtue of this treaty for any purpose other than that contemplated herein and the Reinsurer's internal purposes.

Notwithstanding the above, the Company reserves the right to withhold from the Reinsurer any Privileged Documents. However, the Company shall permit and not object to the Reinsurer's access to Privileged Documents in connection with the underlying claim reinsured hereunder following final settlement or final adjudication of the case or cases involving such claim, with prejudice against all claimants and all parties to such adjudications; the Company may defer release of such Privileged Documents if there are subrogation, contribution, or other third party actions with respect to that claim or case, and the Company's defense might be jeopardized by release of such Privileged Documents.

In the event that the Company seeks to defer release of such Privileged Documents, it shall, in consultation with the Reinsurer, take other steps as reasonably necessary to provide the Reinsurer with the information it reasonably requires to indemnify the Company without causing a loss of such privileges or protections. The Reinsurer shall not have access to Privileged Documents relating to any dispute between the Company and the Reinsurer."

For purposes of this Article:

1. "Privileged Documents" means any documents that are Attorney-Client Privilege Documents and/or Work Product Privilege Documents.
2. "Attorney-Client Privilege Documents" means communications of a confidential nature between
 - a. the Company, or anyone retained by or at the direction of the Company, or its in house or outside legal counsel, or anyone in the control of such legal counsel, and
 - b. any in-house or outside legal counsel, if such communications relate to legal advice being sought by the Company and/or contain legal advice being provided to the Company.
3. "Work Product Privilege Documents" means communications, written materials and tangible things prepared by or for in-house or outside counsel, or prepared by or for the Company, in anticipation of or in connection with litigation, arbitration, or other dispute resolution proceedings.

Example Four

The Reinsurer may at its own expenses at any time during normal office hours audit, inspect and take copies of the Reinsured's books, records and documents which relate to business reinsured under this contract. It is agreed that the Reinsurer's right of audit and inspection shall continue as long as either party has a liability against the other arising out of this contract. Notification of such visit

shall normally be given 2 weeks in advance and, even in urgent cases, at least 48 hours in advance.

Example Five

The Company shall place at the disposal of the Reinsurer, and the Reinsurer shall have the right to inspect, through its authorized representatives, at all reasonable times during the term of this Contract and thereafter, the books, records and papers of the Company pertaining to the reinsurance provided hereunder. Notwithstanding the above, the Reinsurer shall not have any right of access to such books, records and papers of the Company if it is not current in all undisputed payments due the Company. "Undisputed" as used herein shall mean any amount that the Subscribing Reinsurer has not contested in writing to the Company that specifies the reason(s) why the payments are disputed.

Example Six

A. The Reinsurer or its duly designated representative shall have, upon providing reasonable advance notice to the Company, access to the Company's underwriting, accounting and claim files, other than attorney-client or legal professional privileged communications, pertaining to the subject matter of this Contract during the period that this Contract is in force and subsequent to its termination or expiration, except as limited herein. In this regard the Reinsurer's right to inspect underwriting records, premium books and premium records shall terminate five years after termination or expiration of this Contract. However, the Reinsurer shall retain the right to inspect underwriting records and premium records associated with a specific claim until such claim is closed. With respect to closed claims, the Reinsurer's right to inspect claim files, or the underwriting records, premium books and premium records pertaining to such closed claims, shall terminate one year after the closing date of the claim; provided, however, that if the Reinsurer ceases underwriting the business relevant to this Contract, the Reinsurer's right to inspect such records relating to closed claims shall terminate six months after the closing date of the claim. Nothing in this Article requires the Company to maintain or to make available any document for a period longer than that required under the Company's document retention policies and procedures.

B. Notwithstanding the foregoing, if any amount is overdue from the Reinsurer to the Company for any reason, the Reinsurer shall have such access to records only upon payment of such overdue amounts to the Company. The Reinsurer may, at its own expense, reasonably take copies of such books and records and in such event agrees to pay the Company's reasonable costs (including staff expense and other overhead costs) in procuring such copies.

C. If the Reinsurer makes any inspection of the Company's claim files under this Contract and, as a result of the inspection the claim is contested or disputed, the Reinsurer shall provide the Company, at the Company's request, a copy of any reports completed by the Reinsurer's personnel or by third parties on behalf of the Reinsurer outlining the findings of the inspection and identifying the reasons for

contesting or disputing the subject claim. The Reinsurer shall provide the Company with a copy of any such report within 15 days of its finalization by the Reinsurer.

Example Seven

A. The Company shall place at the disposal of the Reinsurer at all reasonable times, and the Reinsurer shall have the right to inspect (and make reasonable copies) through its designated representatives, all non-privileged books, records and papers of the Company directly related to any reinsurance hereunder, or the subject matter hereof, provided that if the Reinsurer is a Run-Off Reinsurer and active in the reinsurance market, this right of access shall be subject to that Reinsurer being current in all payments owed to the Company that are not currently the subject of a dispute. For the purposes of this Article, “non-privileged” refers to books, records and papers that are not subject to the Attorney-client privilege and Attorney work product doctrine. The term “dispute” shall be as defined consistent with the NAIC Annual Statement Instructions.

B. “Attorney-client privilege” and “Attorney-work product” shall have the meanings ascribed to each by statute and/or the court of final adjudication in the jurisdiction whose laws govern the substantive law of a claim arising under a Policy reinsured under this Contract.

C. Notwithstanding the foregoing, the Company shall permit and not object to the Reinsurer’s access to privileged documents in connection with the underlying claim reinsured hereunder following final settlement or final adjudication of the case or cases involving such claim; provided that the Company may defer release of such privileged documents if there are subrogation, contribution, or other third party actions with respect to that claim or case, which might jeopardize the Company’s defense by release of such privileged documents. In the event the Company shall seek to defer release of such privileged documents, it will, in consultation with the Reinsurer, take other steps as reasonably necessary to provide the Reinsurer with the information it reasonably requires to evaluate exposure, establish reserves or indemnify the Company without causing a loss of such privileges. The Reinsurer, however, shall not have access to privileged documents relating to any dispute between the Company and the Reinsurer. Furthermore, in the event that the Reinsurer demonstrates a need for information contained in privileged documents prior to the resolution of the underlying claim, the Company will endeavor to undertake steps as reasonably necessary to provide the Reinsurer with the information it reasonably requires to indemnify the Company without causing a loss of such privilege.

Example Eight

The Reinsurer, by its duly appointed representatives, shall have the right at any reasonable time to examine and take copies, at its own expense, of all records of the Company referring to business effected hereunder. Notwithstanding the above, and except as respects payments in dispute between the Company and the

reinsurer, the Reinsurer shall not have the right of access to the Company's records if it is not current in all payments due the Company.

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PANEL ON REINSURANCE CONTRACT LAW

**UNIDROIT
Villa Aldobrandini
Via Panisperna 28, Rome**

10 May 2019 11.30 am



- 11.30 - 11.40 Welcome and Introduction – Professor Alberto Mazzoni
(President of the UNIDROIT Governing Council)
- 11.40 - 12.00 Introduction to the Principles of Reinsurance Contract Law and their Relationship
with the UNIDROIT Principles on International Commercial Contracts – Professor
Helmut Heiss (University of Zurich)
- 12.00 - 12.20 “Duties” and “Remedies” in the Principles of Reinsurance Contract Law as
compared with the UNIDROIT Principles on International Commercial Contracts –
Professor Diana Cerini (Milano Bicocca University)
- 12.20 - 12.40 A Direct Insurer’s View - Lari Kuitunen (If P&C Insurance)
- 12.40 - 13.00 A Reinsurer’s View – Eberhard Witthoff (Munich Re Group)
- 13.00 - 13.30 Discussion



Professor Dr. Helmut Heiss, LL.M. is full professor at the University of Zurich and attorney-at-law. He has in-depth knowledge and considerable experience in various areas of private law, in particular insurance and reinsurance contract law as well as private international law. Helmut Heiss also acts as Chairman of the Working Group on the Principles of European Insurance Contract Law (PEICL) and of the Working Group on the Principles of Reinsurance Contract Law (PRICL).



Diana Cerini is Full Professor of Comparative Private Law at the School of Law of Università degli Studi di Milano Bicocca. She is the author of several books and papers regarding, among others, insurance law, financial services and tort law. She has conducted researches at national and international level and has been visiting professor in various foreign universities. She has been a member of the Arbitration Committee of the Bank of Italy – Arbitro Bancario Finanziario in charge of resolution of conflicts between banks and other financial intermediaries and clients and has long experience in legal counselling and arbitration. She has been the Italian member of the PEICL (Principles of European Insurance Contract Law) and actually of the PRICL Group (on Principles of Reinsurance Contract Law).



Lari Kuitunen has been a Reinsurance manager at If P&C Insurance Ltd, for close to 10 years. If P&C is one of the largest insurance companies in the Nordics (in fact the largest if you look at Nordic countries as a combined entity). He obtained a Master of Economics at the University of Helsinki in 2007, and a Master of Laws at the University of Helsinki in 2010, his Master's thesis concerning the liability of reinsurers to compensate losses in certain special circumstances, awarded for excellence. His industry expertise has seen him in charge of the negotiation, contract drafting, operation and overseeing of long tail reinsurance contracts. He is a Member of the advisory panel of insurers of the PRICL project



Dr. Eberhard Witthoff has been Head of Claims Munich Re since 2016 for Global Clients and the Asia-Pacific region. He has the worldwide responsibility for Cyber claims, Casualty, Credit risk and Agro. Eberhard began his career as an insurance and contract lawyer in a law firm in Munich serving clients nation-wide, and joined Munich Re as a primary (fire/industrial) insurance specialist in 1997. From 2001 to 2005, he was Senior Claims Lawyer for the German market. In 2005 he became Head of Claims for Central Eastern Europe. From 2007 to 2016 he has been Head of Claims in the Germany, Asia-Pacific, and Africa Division.