YELDHAM PRICE O'BRIEN LUSK

REINSURANCE AND ARBITRATION

Introduction

On 5 October 2011 the High Court delivered judgment in *Westport Insurance Corporation v Gordian Runoff Ltd* [2011] HCA 37 upholding the appeal of the reinsurers in a reinsurance dispute concerning:

- the application of section 18B(1) of the *Insurance Act 1902* (NSW) (***Insurance Act***) to contracts of reinsurance; and
- the applicable criteria for appeals from arbitration awards as provided for by the *Commercial Arbitration Act* 1984 (NSW) and in particular the adequacy of arbitrators' reasons.

Whilst the application of the *Insurance Act* to reinsurance contracts has limited application (contracts entered into after 1 September 2009 have been exempted from section 18B(1) of the *Insurance Act*)[1] the court's consideration of and findings in relation to the *Commercial Arbitration Act* 1984 (NSW) and in particular what constitutes adequate reasons from an arbitrator are of significance to the reinsurance industry and to users of commercial arbitrations.

Background

The Arbitration

The dispute concerned a claim for indemnity under three excess of loss reinsurance treaties. The treaties covered certain professional indemnity and D&O insurance contracts written by Gordian and attaching in the period 1 January 1999 to 31 March 2000 (the latter was extended to 30 June 2000).

The reinsurance treaties were governed by the law of New South Wales and contained an arbitration clause.

During the period of the reinsurance treaties, Gordian agreed to accept a 60% share of a D&O runoff policy for FAI Insurance Limited which provided cover in respect of any claims that might arise in a seven year period after 31 May 1999 (**FAI D&O runoff policy**). The FAI D&O runoff policy was purchased as a result of the acquisition of FAI by HIH.

Gordian notified circumstances that may give rise to a claim under the treaties on 23 February 2001. The reinsurers subsequently denied indemnity for the claim on the basis that the treaties only covered applicable policies which had up to three year reporting periods and thus not the FAI D&O runoff policy in respect of which the claim was made which had a seven year reporting period.

Gordian responded to the reinsurers' denial by arguing that section 18B(1) of the *Insurance Act* applied to the reinsurance treaties and entitled it to indemnity for the claim.
Section 18B(1) of the *Insurance Act* reads as follows:

> (1) Where by or under the provisions of a contract of insurance entered into, reinstated or renewed after the commencement of this section:
>
> (a) the circumstances in which the insurer is bound to indemnify the insured are so defined as to exclude or limit the liability of the insurer to indemnify the insured on the happening of particular events or on the existence of particular circumstances, and

[1] *Insurance Regulation* 2009 (NSW)

(b) the liability of the insurer has been so defined because the happening of those events or the existence of those circumstances was in the view of the insurer likely to increase the risk of loss occurring,

the insured shall not be disentitled to be indemnified by the insurer by reason only of those provisions of the contract of insurance if, on the balance of probability, the loss in respect of which the insured seeks to be indemnified was not caused or contributed to by the happening of those events or the existence of those circumstances, unless in all the circumstances it is not reasonable for the insurer to be bound to indemnify the insured.

The reinsurers argued that section 18B(1) of the *Insurance Act* did not apply to contracts of reinsurance or alternatively its construction was to be considered against the background that it was introduced to protect consumers of insurance products without any specific focus upon contracts of reinsurance. Gordian argued that section 18B(1) applied and in so doing relied on case law which concluded that contracts of insurance (unless otherwise defined) encompassed contracts of reinsurance.[2]

The reinsurers otherwise argued that section 18B(1) of the *Insurance Act* was concerned with the operation of the scope of cover, namely limitations or exclusions affecting the insuring clause. They argued that this was not a case where section 18B(1) applied because there was no cover under the treaties in the first place.

The dispute was determined in favour of Gordian by a panel of three arbitrators (including a prominent retired judge and two reinsurance experts). The panel essentially found that Gordian was entitled to take advantage of section 18B(1) of the *Insurance Act* because the seven year period of the FAI D&O runoff policy was a 'limitation' that did not cause or contribute to the claims made under that policy because those claims were made and notified within the first three years of the policy.

Appeal to single Judge

The reinsurers sought leave to appeal the determination of the arbitrators pursuant to the *Commercial Arbitration Act* 1984 (NSW). Under the *Commercial Arbitration Act* 1984 (NSW) (which applies to contracts governed by New South Wales law) and subject to written agreement between the parties:

- an arbitrator may determine any question that arises for determination by reference to considerations of general justice and fairness (section 22(2));
- an arbitrator is required to include in the award a statement of the reasons for making the award (section 29(1)(c));
- the court has authority to hear an appeal on any question of law arising out of an award but only if the court considers that:
  - having regard to all the circumstances the determination of the question of law could substantially affect the rights of one or more of the parties (section 38(5)(a));
  - there is a manifest error of law on the face of the award (section 38(5)(b)(i)); or
  - there is strong evidence that the arbitrator made an error of law and the determination of that question may or may be likely to, add substantially to the certainty of commercial law (section 38(5)(b)(ii)).

The application for leave to appeal came before Einstein J who granted leave to appeal only on the question of whether there was an error in relation to the application of section 18B(1) of the *Insurance Act*. Whilst his Honour found that section 18B(1) applied to contracts of reinsurance, he found in favour of the reinsurers and concluded that the section did not apply to the terms of the treaty that defined the scope of reinsurance in the circumstances.

Appeal to the Court of Appeal

Gordian sought leave to appeal the decision of Einstein J to the New South Wales Court of Appeal and the reinsurers cross appealed against Einstein J's decision that section 18B(1) of the *Insurance Act* applied to the contracts of reinsurance. The leave to appeal application and

[2] *HIH Casualty & General Insurance v R J Wallace* (2006) 68 NSWLR 603

the cross appeal were heard together. The Court of Appeal granted Gordian leave to appeal, allowed the appeal and dismissed the cross appeal. In doing so, the Court of Appeal made a number of statements about the history and application of section 18B(1) to contracts of reinsurance although the appeal focused on the arbitration issues.

Whilst the Court of Appeal recognised that the construction of section 18B(1) of the *Insurance Act* was not without difficulty and the statutory objective of the section '*was to remedy a perceived commercial mischief whereby insurers were able to avoid liability on claims otherwise based on exclusions or terms operative upon, or triggered by, events that had no relationship to the cause of the event giving rise to the loss and the claim in question'* and was thus directed solely to consumer protection (without consideration of its application to contracts of reinsurance), the Court of Appeal found that the arbitrators were entitled to place a broad construction upon the section as contended for by Gordian.

The Court of Appeal (particularly having regard to its conclusions in relation to section 18B(1) of the *Insurance Act*) found no manifest error on the part of the arbitrators which attracted the operation of section 38 of the *Commercial Arbitration Act* 1984 (NSW) (and in particular section 38(5)(a) or (b)).

The Court of Appeal went on to find that the reasons provided by the arbitrators were adequate and consistent with those required by section 22(2) of the *Commercial Arbitration Act* 1984 (NSW) and rejected the reinsurers submission that the arbitrators were required, at a minimum, to state the chain of reasoning as to why the ultimate conclusion flowed from the primary facts as found.[3]

Appeal to High Court

On the application for special leave to appeal to the High Court the reinsurers contended that the arbitrators in effect gave no reasons (and certainly no adequate reasons) in relation to the proviso to section 18B(1) of the *Insurance Act* or section 22(2) of the *Commercial Arbitration Act* 1984 (NSW).

The reinsurers argued that it was insufficient for the arbitrators in effect simply to state their conclusion in the terms they did and it was wrong for the Court of Appeal to find otherwise. They submitted that a complex dispute attended by the formalities of legal proceedings required reasons of a judicial standard and that the Court of Appeal's approach meant that the arbitrators (unlike a judge) were not required to reveal their reasons, their process of reasoning or identify the material considerations that led to their conclusions.

The reinsurers pointed out that because the decision of the Court of Appeal is starkly conflicting with a decision of the Victorian Court of Appeal (*Oil Basins v BHP*), a determination of the question as to the standard of reasons to be expected from commercial arbitrators in Australia is a matter of significant importance not only to the reinsurance industry but also to users of commercial arbitration at large.

The High Court granted special leave to consider the following questions:

- The New South Wales Court of Appeal erred in failing to conclude that the arbitrators had not given any, or any adequate, reasons as required by section 29(1) of the *Commercial Arbitration Act* 1984 (NSW) for the conclusions that:
  - it was reasonable for the appellants to be required to indemnify the respondent within the meaning, and on the proper construction, of the proviso to section 18B(1) of the *Insurance Act*;
  - considerations of general justice and fairness did not compel the conclusion that the appellants should not be required to indemnify the respondent within the meaning, and on the proper construction, of section 22(2) of the *Commercial Arbitration Act* 1984 (NSW).

[3] The reinsurers relied upon the decision of the Victorian Supreme Court in *Oil Basins v BHP Billiton* (2007) 18 VR 346

The High Court also referred the following grounds to the full court hearing for further consideration:

- The New South Wales Court of Appeal erred in failing to conclude, on its proper construction, that section 18B(1)(a) of the *Insurance Act* had no application to the terms of the reinsurance contracts (as found by the arbitrators) that identified which underlying insurance contracts written by the respondent were covered by the reinsurance contracts;
- Having correctly concluded that the existence of the underlying insurance contract with a reporting period of seven years was the cause of the respondent's loss within the meaning of section 18B(1) of the *Insurance Act*, the New South Wales Court of Appeal erred in failing to conclude that the arbitrators' contrary conclusion was an error of law (alternatively, an error in relation to a mixed question of fact and law) within the scope of section 38(5)(b)(i) and/or section 35(b)(ii) of the *Commercial Arbitration Act* 1984 (NSW).

Judgment of the High Court

French CJ, Gummow, Crennan, Bell JJ (in a joint judgment) and Kiefel J (in a separate judgment) found in favour of the reinsurers on both the arguments in respect of section 18B(1) and the insufficiency of the arbitrators' reasons. As a result, the majority concluded that the award was the product of a manifest error of law and should be set aside.

Whilst the court recognised the remedy for the inadequacy of reasons was usually to remit the matter to the arbitrators for reconsideration, the success of the reinsurers in relation to the section 18B(1) argument made it appropriate to set aside the award and in effect restore the findings of the primary judge.

Section 18B of the *Insurance Act*

The majority held that section 18B(1) was not engaged and that, as a result, the arbitration was the product of a manifest error of law which attracted the operation of section 38(5)(b)(1) of the *Commercial Arbitration Act* 1984 (NSW). French CJ, Gummow, Crennan and Bell JJ held: [4]

> A policy which is limited to three year reporting periods is not a policy with a seven year period, as was the situation with the FAI policy. It is no answer that three year claims might fall within both policies. The exclusion upon which the treaties operated was in respect of "policies issued for periods longer than 36 months".
>
> There was in the provisions of the treaties no stipulation by or under which (in the terms of section 18B) the reinsurers excluded or limited their liability to indemnify Gordian by reason of the circumstance that the FAI policy had the seven year period, so that Gordian thereby was disentitled to what otherwise would have been its right to indemnity under the treaties. The words in section 18B(1)(a), "on the happening of particular events or on the existence of particular circumstances", mark off exclusions and limitations from the content of the "contract of insurance" identified in the opening words of the sub-section. Accordingly, section 18B was never engaged.

Arbitrators reasons

In respect of the argument as to the adequacy of the arbitrators' reasons, the findings of the majority[5] as to the principles can be summarised as follows:

- '*no wholly satisfactory formula can be found to flesh out the requirement*' that an arbitrator is required to include in his award a statement of the reasons for making the award as required by section 29(1)(c) of the *Commercial Arbitration Act* 1984 (NSW);[6]

[4] at [61] and [62]

[5] at [51]-[59] and [169]-[170]

[6] at [54]

- as a general principle the English authority on this issue was applicable. The majority (as did the Court of Appeal) cited with approval the statement of Donaldson LJ in *Bremer* where his Lordship said:[7]

> All that is necessary is that the arbitrators should set out what, on their view of the evidence did or did not happen and should explain succinctly why, in the light of what happened, they have reached their decision and what that decision is. That is all that is meant by a 'recent award'.

- the reference in previous Australian authority (*Oil Basins v BHP*) to the giving by arbitrators of '*reasons to a "judicial standard" and cognate expressions placed an unfortunate gloss upon the terms of section 29(1)(c)*' of the *Commercial Arbitration Act* 1984 (NSW). The court held that the more important observations in that authority were to the effect that '*what is required to satisfy that provision will depend upon the nature of the dispute and the particular circumstances of the case*'.

- French CJ, Gummow, Crennan and Bell JJ found the following in respect of the application of those principles in this case: [8]

> Treating s 18B of the *Insurance Act* as a critical element in reaching their award, the arbitrators were obliged to explain succinctly why the various integers in that complex statutory provision were satisfied. Those integers included the proviso.
>
> There is no indication of factual findings in the Reasons [sic] which supported the inapplicability of the proviso, nor, indeed, of those considerations tending to support its application. In particular, there was no apparent attention to the contention that Gordian could have sought a special acceptance with respect to the FAI policy but had not done so, and if Gordian had done so it was at best conjectural that the reinsurers would have accepted. Nor was there consideration of the reinsurers' rejoinder pleading concerning the adjustment in premium. Nor was there any apparent consideration that the proviso in s 18B(1) was designed to guard against a strained application of the sub-section. (emphasis added)

- Kiefel J concluded: [9]

> I agree with French CJ, Gummow, Crennan and Bell JJ that what is required by way of reasons in a given case will depend upon the circumstances of that case. In this case the arbitrators could not apply s 18B(1) without determining whether it was reasonable to hold the reinsurers bound to indemnify Gordian in all the circumstances. More was therefore required than a statement of conclusion. It was necessary that they say why it was reasonable to do so, in order to fulfill the requirement of s 29(1)(c). The failure to do so constituted an error of law. (emphasis added)

Heydon J delivered a dissenting judgment dismissing the reinsurers' appeal and in doing so made the following observation about the '*merits of arbitration'* having regard to the circumstances of this case: [10]

> The arbitration proceedings began on 15 October 2004 when Gordian served points of claim. This appeal comes to a close seven years later. The attractions of arbitration are said to lie in speed, cheapness, expertise and secrecy. It is not intended to make any criticisms in these respects of the arbitrators, of Einstein J, or of the Court of Appeal, for on the material in the appeal books none are fairly open. But it must be said that speed and cheapness are not manifest in the process to which the parties agreed. A commercial trial judge would have ensured more speed and less expense. On the construction point it is unlikely that the arbitrators had any greater relevant expertise than a commercial trial judge. Secrecy was lost once the reinsurers exercised their right to seek leave to appeal. The proceedings reveal no other point of superiority over conventional litigation. One point of inferiority they reveal is that there have been four tiers of adjudication, not three. Comment on these melancholy facts would be superfluous.

Observations

This judgment brings into line the Australian approach to the adequacy of reasons for an arbitrator's award with the approach in England (although the majority pointed out that on

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[7] *Bremer Handelsgesellschaft mbH v Westzucker GmbH (No 2)* [1981] Lloyd's Rep 130 at 132-133

[8] at [55] and [56]

[9] at [170]

[10] at [111]

proper consideration of the previous Australian authority there had been no real difference in approach). Whilst the court has not held arbitrators to a 'judicial standard' it nevertheless makes clear that, depending on the circumstances of each case, arbitrators are required to give reasons as to why conclusions are reached and are not permitted to simply state the conclusions.

The reasoning of the High Court remains relevant and applicable even though the *Commercial Arbitration Act* 1984 (NSW) was repealed and replaced with the *Commercial Arbitration Act* 2010 (NSW) (**the new Act**) on 1 October 2010. The new Act is based on and supplements the United Nations Commission on International Trade Law (**UNCITRAL**) Model Law on International Commercial Arbitration and is designed to bring the legislation governing '*domestic arbitrations*' in line with the Model Law and the position federally[11].

Whilst the new Act arguably limits some of the grounds of appeal from arbitration awards,[12] it maintains the requirement that the arbitration award must '*state the reasons upon which it was based*'.[13]

It should be remembered that the old Act operated (as with the new Act) subject to other terms of arbitration clauses. It remains open to parties to agree to terms that otherwise dictate or limit the process. Whilst the High Court's decision will have important general application (because in a large number of cases the legislative provisions apply), it remains important to consider the particular terms of the arbitration clause in each case.

It is likely that this judgment will cause arbitrators to be more expansive in their reasons and thus adopt something more akin to a judicial standard. As we observed in our article on this topic in October 2010[14], this trend is likely to lead to greater scope for the identification of error and increase the capacity to appeal from awards. This raises a question as to the difference between commercial arbitration and commercial litigation echoing the observations as to the merits of arbitration made by Heydon J in his dissenting judgment.

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This article was prepared by Timothy Price, Director and Hector Menendez, Solicitor. Timothy Price can be contacted on 9231 7022 or at tprice@ypol.com.au and Hector Menendez can be contacted on 9231 7011 or at hmenendez@ypol.com.au

[11] *International Arbitration Act* 1974

[12] The Court must not grant leave unless it is satisfied:

(a) that the determination of the question will substantially affect the rights of one or more of the parties, and

(b) that the question is one which the arbitral tribunal was asked to determine, and

(c) that, on the basis of the findings of fact in the award:

(i) the decision of the tribunal on the question is obviously wrong, or

(ii) the question is one of general public importance and the decision of the tribunal is at least open to serious doubt, and

(d) that, despite the agreement of the parties to resolve the matter by arbitration, it is just and proper in all the circumstances for the Court to determine the question. (section 34A(3) of the new Act)

[13] See section 31(3) of the *Commercial Arbitration Act* 2010 NSW and 29(1) of the *Commercial Arbitration Act* 1984 (NSW).

[14] YPOL reinsurance and arbitration update, October 2010

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LEVEL 2, 39 MARTIN PLACE
SYDNEY NSW 2000

DX 162 SYDNEY

T: +61 2 9231 7000
F: +61 2 9231 7005
WWW.YPOL.COM.AU

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YELDHAM PRICE O'BRIEN LUSK
ACN 109 710 698

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