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REINSURANCE AND ARBITRATION

Introduction

On 3 September 2010, the High Court granted special leave to appeal the decision of the New South Wales Court of Appeal in *Gordian Runoff Limited v Westport Insurance Corporation* [2010] NSWCA 57 paving the way for the rare consideration by the High Court of a reinsurance dispute.

The appeal is expected to deal with:

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

Whilst the application of the *Insurance Act* 1902 NSW (**Insurance Act**) to reinsurance contracts is likely to give rise to some consideration of reinsurance principles, it is to be noted that contracts entered into after 1 September 2009 have been subsequently exempted from section 18B(1) of the *Insurance Act*[1]. In any event, the arbitration issues will be of significant interest beyond the reinsurance industry to all users of commercial arbitrations.

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 may 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 seven year reporting period provided for under the FAI D&O runoff policy in respect of which the claim was made.

Gordian responded to the reinsurers denial by arguing that sections 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) Whereby or under the provisions of a contract of insurance entered into, reinstated or renewed after the commencement of this section:
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> (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
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> (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,

[1] The Insurance Regulation 2009 (NSW) and YPOL *Reinsurance Update June 2009*

> 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 (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 in 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 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*

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

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* (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] Instead, the Court of Appeal followed English authority:

> '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'.'[4]

Special Leave and the 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 to simply 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 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 sec 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 sec 18B(1) of the *Insurance Act* 1902 (NSW);
  - 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 sec 22(2) of the *Commercial Arbitration Act* 1984 (NSW).

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 sec 18B(1)(a) of the *Insurance Act* 1902 (NSW) 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;

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[3] The reinsurers relied upon the decision of the Victorian Supreme Court in *Oil Basins v BHP Billiton* (2007) 18 VR 346 at 364-5.

[4] Bremer Handelsgesellschaft mbH v Westzucker GmbH (no. 2) [1981] 2 Lloyds rep 130 at 132-133 and Bay Hotel and Resort Ltd v Cavalier Construction Co Ltd [2001] UK PC 34

- 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 sec 18B(1) of the *Insurance Act* 1902 (NSW), 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 sec 38(5)(b)(i) and/or sec 35(b)(ii) of the *Commercial Arbitration Act* 1984 (NSW).

Observations

As can be seen from the terms of the grant of special leave, the appeal is likely to focus upon the question of what constitutes sufficient reasons in an arbitral award determined by the application *Commercial Arbitration Act* 1984 (NSW). The court will determine whether it is:

- sufficient for arbitrators to set out their decision with limited reasoning as a just approach endorsed by the Court of Appeal in New South Wales (consistent with English authority); or
- a 'judicial standard' which includes not only the decision but an explanation of the chain of reasoning as endorsed by the Victorian Court of Appeal.

The determination of this question will provide clarity and certainty as to the correct approach under Australian law and will be of interest to all users of commercial arbitration.

Whilst adopting the judicial reasoning approach would arguably make arbitrations more transparent by exposing the arbitrators' detailed reasons for an award, it is likely to lead to greater scope for the identification of error and increase the capacity to appeal from a determination. It might also be suggested that this is a further extension of a trend where commercial arbitrations are becoming increasingly similar, in all respects, to commercial litigation leaving only their private nature and the ability to select the arbitrators as the only real distinctions between the two dispute resolution processes.

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[5].

On the special leave application, Gordian argued that the new Act (which had not at the time been proclaimed) meant that these issues had limited historical significance to New South Wales arbitrations and probably arbitrations in other states (which are expected to follow the legislative changes in New South Wales). In particular, Gordian pointed to the changes under the new Act to the grounds of appeal from arbitration awards which arguably provided more limited scope for appeals than was the case under the old Act[6]. With little debate, the court did not accept this argument as a reason against granting special leave. This is perhaps unsurprising because the new Act (like the old Act) requires the arbitration award to '*state the reasons upon which it is based'*[7] and provides no further direction or content as to the form the reasons should take. Thus, the debate highlighted by this article is relevant and applicable to the position under the old Act and new Act even though the grant of special leave, in terms, is in respect of the old Act.

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 the parties to agree terms which otherwise dictate or limit the process. Whilst the High Court's decision will have important general

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[5] *International Arbitration Act* 1974 (Cth).

[6] 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.

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

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.

The extent to which the High Court otherwise considers reinsurance principles and the ongoing debate about the application of the *Insurance Act* to contracts of reinsurance entered into prior to 1 September 2009 is perhaps less predictable. On the special leave application, Gordian argued that these issues had less significance given the exemption of reinsurance contracts entered into after 1 September 2009 (when by regulation contracts of reinsurance were exempted from the operation of the section). However, the reinsurers pointed out that the application and construction of section 18B(1) remains significant for contracts entered into prior to 1 September 2009 and this may have an unknown broader impact, particularly for contracts where claims and the dispute have not yet crystallised. While some comment from the High Court is expected on these issues, the extent to which the court deals with them in detail is likely to depend upon whether the Court entertains the grounds reserved for further consideration for special leave.

In any event, the arbitration issues alone remain significant for the reinsurance industry where arbitration clauses remain commonplace and a significant reason why (at least to date) there remains limited appellant consideration of reinsurance issues in Australian courts. Accordingly, a High Court appeal in this area, is a rare and important event.

The High Court judgment can be expected in about the middle of 2011.

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