Introduction

Reinsurance contracts traditionally have been considered "gentlemen's agreements." In modern times, reinsurance contracts have moved away from the handshake agreements of yesterday and focus more on the realities of the bottom line. Reinsurance contracts often, if not always, especially reinsurance treaties, contain an arbitration clause. Hence, should a dispute arise, it will be resolved by resort to arbitration. Reinsurance arbitration differs markedly from commercial arbitration in other industries. Even if one forgets for a moment that the traditional reinsurance relationship is the reason why arbitrations occur in the reinsurance industry, and perhaps offers the greatest advantage for using arbitration, there also other numerous advantages to using arbitration alongside some disadvantages. Still, arbitration remains the preferred dispute resolution method in reinsurance.

1.1 General

Reinsurance is a transaction in which an insurance company (the primary insurer or reinsured) cedes all or part of a risk of loss to another insurance company (the reinsurer). In return for agreeing to indemnify the reinsured for losses that may occur, the reinsurer receives premiums from the reinsured.[1] Reinsurance contracts often, if not always, especially reinsurance treaties, contain an arbitration clause. Hence, should a dispute arise, it will be resolved by resort to arbitration.

Many people ask, what is the difference between litigation and arbitration today anyway? Commercial arbitration, especially reinsurance arbitration, has become complex, costly, and time consuming. Fundamentally, there is no difference

[1] This practice is not limited to a primary insurance company and a reinsurer. It is commonplace for a reinsurer to turn around and retrocede risk to another reinsurer. In that transaction, the reinsurer is known as the retrocedent, and the insurance company assuming the risk of loss is the retrocessionaire; McDonald (2001), p. 328.

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between litigation and arbitration because in each proceeding, a neutral third party decides the dispute between the parties and issues a binding decision. Procedurally, however, there are dramatic differences. Arbitration is a consensual dispute resolution mechanism generally founded on a contract provision that requires all disputes to be resolved by arbitration instead of litigation. Because it is generally a contract right, courts enforce arbitration clauses.[2]

Perhaps, the biggest difference between litigation and arbitration is the decider of the dispute. In court, of course, it is a state-court judge who is appointed. In arbitration, the decider is an arbitrator or a panel of arbitrators, who are private citizens being paid by the parties to resolve the dispute. In reinsurance, the practice has been to have a panel of three arbitrators often—but not always—chosen from either active or former executive officers of insurance or reinsurance companies. In other words, industry "experts" act as the arbitrators in reinsurance disputes.

Another big difference is the rules. In court, litigation is governed by either state or federal procedural rules. These rules cover all aspects of the litigation, from commencement through appeals. In commercial arbitration there may or may not be rules. The rules in commercial arbitration may come from arbitral bodies or be formed *ad hoc* by parties.

In reinsurance disputes, the parties may agree to use procedures promulgated over the years by a task force of insurance and reinsurance industry professionals, or may agree to procedures before the arbitration panel that suit both the parties and the arbitrators. Unlike other forms of commercial arbitration, it is rare that a reinsurance arbitration will take place under the auspices of an arbitral organization, or tribunal with rules and procedures that must be followed.

Flexibility of the process is another significant difference between litigation and arbitration. In court, there is very little flexibility as the venue will be the courthouse and the civil procedure rules make clear how the process will unfold. In arbitration, the parties and the arbitrator may find that the arbitration hearing should be held in more than one location or that only briefs and oral argument are necessary to decide the case. Because commercial arbitration is a private, confidential, and consensual procedure, the parties and the arbitrator may adopt unique methods for resolving the dispute.

Undoubtedly, a huge difference between litigation and arbitration is confidentiality, for, in arbitration, the process is private and confidential.

Finally, another major difference is the ability to appeal. In court, the right of appeal exists by statute. In commercial arbitration, generally there is no right of appeal. While there are some ways to challenge an arbitration award, courts construe these grounds narrowly, and it is rare to see an arbitration award vacated.

As stated already, most reinsurance contracts, especially reinsurance treaties, contain an arbitration clause. However, arbitration clauses in reinsurance contracts

[2] In the USA a federal policy in favour of arbitration developed many years ago and was made part of the law by Congress when the FAA was enacted. Most states also favour arbitration and have similar laws and court decisions enforcing arbitration clauses; Schiffer (2006).

tend to be very broad. This means that virtually any dispute or disagreement concerning the interpretation or application of any part of the reinsurance contract, including its formation, must be decided by arbitration.

Reinsurance arbitration differs markedly from commercial arbitration in other industries. Reinsurance arbitrations are often controlled by the parties and the arbitrators, not by an arbitral body. Most reinsurance arbitrations traditionally do not require adherence to any particular set of rules.

The predominant reinsurance markets are, traditionally, the English and USA markets. However, Germany is also one of the most important reinsurance markets. More than 40 reinsurers, have their business headquarters in Germany. Altogether, they represent around 27 % of the global reinsurance market. Amidst the German reinsurance companies, are two of the biggest, in size—in terms of premium volumes—worldwide, i.e. Munich Re and Hannover Re. In addition, Swiss Re, Zurich Re and Scor Reinsurance have their business quarters in a territory, where German language is also predominantly spoken, i.e. Switzerland.

One may find the reinsurance industry's preference for arbitration as very unusual in the commercial world. Industry experts offer an amalgamation of reasons for this preference, but the most obvious and intimate, from the standpoint of the reinsurer and the reinsured, are the fact that reinsurance treaties are not commonly plain and typical commercial contracts, the fact that arbitrations are not as adversarial in character and physiology as litigation, the fact that discovery rules are more restrictive and lastly the fact that decisions remain between the parties and are neither published nor count as precedent.

The above constitutes a combination of the reasons that produced the traditional reinsurance relationship. One could say using arbitration was never a conscientious decision by the industry participants; rather, it was simply an extenuation of traditional business practices. Much as the traditional reinsurance relationship, arbitration has come under siege in the era of the "new" reinsurance relationship.

1.2 Reinsurance Aspects and History

1.2.1 Reinsurance Treaties

Reinsurance enables insurers to protect themselves against unexpected events and forms a means of managing potential liability.

In England, the Insurance Companies Act 1982 requires insurers to have adequate reinsurance in place and thus it is common practice in Lloyd's for a broker to arrange reinsurance before seeking subscriptions for a primary policy, so as to make the latter a more attractive proposition.[3]

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[3] *General Accident Fire and Life Assurance Corpn v Tanter* (*The* "*Zephyr*") (1985)2 Lloyd's Rep. 529; Lowry and Rawlings (1999), p. 301.

In its simplest form, insurers, having agreed to indemnify the insured against a particular loss, enter into the reinsurance to cover their potential liability under that policy.[4]

Facultative reinsurance is the most basic form of reinsurance business, where the reinsurer chooses or not to accept a particular risk and the reinsured retains a proportion of the risk.[5] In facultative reinsurance, every risk is being considered separately and individually and both insurer and reinsurer have a choice as to whether to enter a reinsurance contract in respect of each risk.[6]

Obligatory or treaty reinsurance is entered into by an agreement usually referred to as a treaty, whereby the reinsured agrees to reinsure primary insurer of a specified class and the reinsurer agrees to accept the business. Both the reinsured and the reinsurer have no choice to deny reinsurance, if the business comes within the class specified in the treaty. Thus, the central distinguishing feature of the treaty method of reinsurance is that the insurer is obliged to cede to the reinsurer such risks, as he has agreed to cede under the treaty and the reinsurer is obliged to accept those risks. It is, as such, the predominant method of reinsurance.[7]

Reinsurance may also be proportional or non-proportional.

In proportional reinsurance, the reinsurers agree, for part of the premium, to take on either an agreed proportion, i.e. a quota share, of all the risks of a particular type or the surplus over a particular amount.[8] The reinsurer has an interest in all the insured's losses as it will pay the proportion of such losses that he has agreed to reinsure, leaving the remainder to be paid by the insurer.[9]

Non-proportional reinsurance covers loss over an agreed amount, divided into excess of loss reinsurance, where the reinsurers are liable for the amount by which individual or aggregated claims on primary policies, exceed an agreed amount and stop loss reinsurance, where the reinsurers are liable above a certain percentage, calculated by the ratio of losses to premium income or as a fixed sum.[10] Thus, in non-proportional reinsurance, the reinsurer is uninterested in any type of loss until it reaches the excess point. For any loss greater than the excess point, the reinsurer pays the part he has insured.[11]

Facultative proportional reinsurance is more frequent than facultative non-proportional reinsurance.[12]

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[4] Butler and Merkin (1999); Lowry and Rawlings (1999), p. 301.

[5] Lowry and Rawlings (1999), pp. 302–303.

[6] Edelman et al. (2005), pp.11–12.

[7] Edelman et al. (2005), pp. 12–13.

[8] Lowry and Rawlings (1999), pp. 303–304.

[9] Edelman et al. (2005), pp. 9–12.

[10] Lowry and Rawlings (1999), pp. 302–304.

[11] *Balfour v Beaumont* [1982] 2 Lloyd's Rep. 493, 496; Edelman et al. (2005), p. 9.

[12] *Forsokringsakteselskapet Vesta v Butcher* (1989)1 Lloyd's Rep 331, 352; Edelman et al. (2005), pp. 9–12.

Under a proportional treaty the insurer agrees to cede a proportional share of its business within the limits of the treaty and the reinsurer agrees to accept the share. The limits of the treaty can be in relation to the risk, its nature or its amount. However, once agreed the reinsurance is automatic, i.e. the insurer is obliged to cede and the reinsurer is obliged to accept all risks that are within the compass of the treaty.

Proportional reinsurance treaties are either quota share proportional reinsurance treaty or surplus proportional reinsurance treaty. By a quota share proportional reinsurance treaty, insurer and reinsurer are obliged to cede and accept a fixed share of each and every risk within the scope of the treaty.[13] By a surplus proportional reinsurance treaty, the reinsurer agrees to accept the liability above that which the insurer wishes to retain for itself. The insurer decides what sum it wishes to cede to the reinsurer depending on the size and type of risk.[14]

Non-proportional reinsurance treaties are based more on claims than risks, and are categorised as either excess of loss or stop loss non proportional reinsurance treaties. In excess of loss non-proportional reinsurance treaties the reinsurer becomes involved only where the loss on any risks exceeds the deductible and becomes liable for the layer of the loss he has agreed to reinsure. Stop loss non-proportional reinsurance treaties may be excess of loss ratio non-proportional reinsurance treaties, whereby the stop loss excess is expressed as a percentage of loss to premium income, and aggregate excess loss non-proportional reinsurance treaty, whereby the stop loss excess is expressed as a particular sum.[15]

1.2.2 The History of Reinsurance

Reinsurance contracts traditionally have been considered "gentlemen's agreements." Business was done on a handshake with written contracts that were brief and arcane. At the commencement of performance of the contract, the only existing documentation of the transaction generally was a placement slip. A reinsurance placement slip is a model of brevity; its terms are restricted to single paragraphs and incorporate only industry boilerplate terms by reference. For instance, if the formal treaty is to include an arbitration clause, the slip would simply state "arbitration clause." Then a treaty would be generated providing a more formal and detailed documentation of the reinsurance contract. Sometimes a formal treaty may never be generated, the only terms of the reinsurance contract being in the placement slip. Formal treaties often were not much clearer than the placement slips. The treaties usually incorporated antiquated language that rarely was read, or for that matter, legally understood.[16]

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[13] Edelman et al. (2005), pp. 12–13.

[14] Edelman et al. (2005), p. 13.

[15] Edelman et al. (2005), p. 15.

[16] McDonald (2001), p. 329.

Reinsurance has its origins in marine insurance and in the first centuries of its existence occurred almost exclusively in its wake. Thus, the histories of these two forms of insurance are closely inter-linked. Even in pre-Biblical times, the Babylonians (4000–3000 BC) used to "insure" ships on the basis of loan contracts under which the interest and the loan itself were (re)paid only if the ship arrived safely at its destination. Under these arrangements, the interest on the loan was the insurance premium, whereas the release from the obligation to repay the loan was the insurance benefit. This kind of marine insurance was also practised by the Hindus (600 BC) and the ancient Greeks and Romans. The historical situation towards the end of the Middle Ages formed the backdrop for the evolution of marine insurance: the city-states of the Mediterranean region had developed into important trading centres thanks to the Crusades, while in northern Europe the Hanseatic League was forming. The result was an upswing in European trade. More and bigger cargoes were being transported by sea, so there was a growing need to hedge the value of the transported goods.

By the end of the fourteenth century there were already several insurance policies in force. Documentation has been preserved to this day. It proves that marine insurance was already spreading around the Mediterranean at this time. In the first half of the sixteenth century, marine insurance became even more important as a result of growth in overseas trade. The insurance providers were mainly private bankers and moneychangers, but also merchants trading with insurance on a professional basis. Especially the Italian merchant dynasties such as the "Medici" were involved in insurance deals. The most important insurance centres were Genoa, Florence and Venice. Trade with Flanders and Holland led to the establishment of insurance business in the "Low Countries" ("Pays-Bas"), too. In England, the first insurance contracts were concluded in the early sixteenth century, in Germany (Hamburg) as of the second half of the sixteenth century. The beginnings of reinsurance likewise date back to the fourteenth century. The first known reinsurance contract was concluded in Genoa back in 1370, whereby the direct insurer promised to indemnify the insured if the latter's ship failed to reach the destination port within a certain time and in case the vessel arrived the insurer would be entitled to sell the cargo as salvage, and, in turn, the reinsurer had promised the direct insurer to buy up the entire cargo.[17] This marked the birth of reinsurance, even if this kind of transaction was still rare at first. The more common form of insurance for large risks at this time was coinsurance, in which several insurers share a risk that would be too big for any one of them to take on, on his own. As trade flourished and economies boomed, the demand for reinsurance cover likewise rose. As the limited possibilities of coinsurance became exhausted, reinsurance became more and more important.

In late-seventeenth-century London, prosperous businessmen used to gather in Edward Lloyd's coffee shop to get the latest news. This meeting place became the

[17] Schwepcke (2004), pp. 1–2.

place to go to buy or sell marine insurance. Apart from everyday insurance contracts, reinsurance agreements were also concluded here. By the end of the seventeenth century, reinsurance had arrived in France and the Netherlands, and in the early eighteenth century it finally reached Germany and the rest of England. The first reinsurers were direct insurers.

In 1720, for example, a Rotterdam insurance Company reinsured four ships that had been insured with another direct insurer in London for a voyage to India. The first description of a reinsurance contract is to be found in the “Guidon de la Mer”, an authoritative treatise on marine insurance (published in Rouen) written by an anonymous author in the second half of the sixteenth century. This document advises that a risk should be reinsured whenever the direct insurer regrets having concluded the insurance contract. The term “reinsurance” came into use in the mid-eighteenth century but did not originally imply any specific form of transaction. It was not until early in the nineteenth century that the modern concept of a reinsurance contract developed.

The first legal regulations on reinsurance were passed in the Low Countries in 1609. The law expressly declares reinsurance allowable. Louis XIV’s “Ordonnances de la Marine”, promulgated in 1681 and amended in 1686, are generally considered the model for modern insurance legislation.

In Germany, the first statutory provisions on reinsurance were embodied in the “Hamburger Assekuranz- und Havarie-Ordnung” of 1731. This served as a prototype for insurance legislation in Denmark, Sweden and Prussia and already contained a Provision governing the direct insurer’s Obligation to provide the reinsurer with full information. The Prussian “Allgemeine Landesrecht für die Preussischen Staaten” of 1794 contains a first comprehensive code of insurance law, including reinsurance law. Articles 2016–2023, for instance, deal with the permissibility, scope and separate legal entity of the reinsurance contract.

In England, King George II enacted a law in 1746 that severely limited marine reinsurance. This was in response to abusive practices involving reinsurance: direct insurers had been offering reinsurance at prices way below the original premiums. According to this law, reinsurance was permissible only in the case of insolvency or death of the original direct insurer. These restrictions were not lifted again until 1864. But even such severe constraints could not curtail the development of reinsurance: the direct insurers’ need and desire to diversify their risks were too strong.

In the eighteenth century, the marine underwriting at Edward Lloyd’s coffee house, the Act of the Parliament of 1745 and the constitution of Lloyd’s as a society in 1811 helped the prosper of reinsurance. In the nineteenth and early twentieth centuries, two important features, i.e. the formation of independent reinsurance companies in continental Europe and the growth of non-marine reinsurance at Lloyd’s, contributed to the further development of the reinsurance market.

In particular industrialisation and urban expansion in the nineteenth century, led to a growing demand for non-marine insurance, particularly fire insurance. The need for reinsurance capacity, at that time, was at first met by the insurance companies writing direct business, acting like the merchants that preceded them, accepting as reinsurers risks from other insurance companies. The earliest known reinsurance treaty was a reciprocal fire treaty between "La nationale compagnie d' assurance" of Paris and the "Compagnie des proprietaires reunis" of Brussels, dating from 1821. In Germany, the first statutory provisions on reinsurance were embodied in the "Hamburger Assekuranz- und Havarie-Ordnung" of 1731. This served as a prototype for insurance legislation in Denmark, Sweden and Prussia and already contained a Provision governing the direct insurer's Obligation to provide the reinsurer with full information. The Prussian "Allgemeine Landesrecht für die Preussischen Staaten" of 1794 contains a first comprehensive code of insurance law, including reinsurance law. Also, a number of German companies formed subsidiaries in order to write fire reinsurance: the first truly independent reinsurance company was the Kölnische Rückversicherungs-Gesellschaft ("Cologne Re"), founded in Cologne in 1843. In 1863, the Swizerische Rückversicherungs-Gesellschaft ("Swiss Re") was founded in Zurich. In 1880, the Munchener Rückversicherungs-Gesellschaft ("Munich Re") was founded in Munich. In England, King George II enacted a law in 1746 that severely limited marine reinsurance. This was in response to abusive practices involving reinsurance: direct insurers had been offering reinsurance at prices way below the original premiums. According to this law, reinsurance was permissible only in the case of insolvency or death of the original direct insurer. These restrictions were not lifted again until 1864. But even such severe constraints, could not curtail the development of reinsurance: the direct insurers' need and desire to diversify their risks were too strong.[18] The first professional reinsurance company in England i.e. the "Reinsurance Company Ltd" was incorporated in 1867. Although the term "reinsurance" came into use in the mid-eighteenth century it did not originally imply any specific form of transaction and was not until early in the nineteenth century that the modern concept of a reinsurance contract developed.

In the nineteenth century, two factors played a significant role in the growth of Lloyd's, i.e. the introduction of the syndicate and, secondly, the move into non-marine underwriting, where Lloyd's proved to have a competitive edge over the more conservative companies.[19]

Notwithstanding the above developments, in the twentieth century, moreover, the profound social, political and economic changes that occurred and the globalisation of the world economy and the world market, all lead to the globalisation of the reinsurance market.[20] Not least, in an effort to cope with new challenges, the business of alternative risk transfer was created to encompass reinsurance and financial or capital market features.[21]

[18] Schwepcke (2004), pp. 1–2.

[19] O'Niell and Woloniecki (1998), pp. 31–32.

[20] O'Niell and Woloniecki (1998), pp. 27–34.

[21] Geiger (2000), pp. 50–51.

1.2.2.1 The Emergence of Professional Reinsurance

In the early days of reinsurance, there were various forms of reinsurance cover: in England and the USA, especially, domestic direct insurance companies reinsured each other. At about the same time, insurance companies all over the world started to look for reinsurance cover in other countries. This was not always easy for German insurance companies, who feared losing their reinsurance cover in the event of a war. To respond to their needs, the first professional reinsurance companies in Germany were founded. For similar reasons, insurers in other countries with global interests endeavoured to become as self-supporting as possible. Although commerce between (re)insurers in different political spheres of interest was possible and indeed was practised in individual cases, it still remained the exception.[22]

1.2.2.2 The Industrial Revolution: The Heyday of Reinsurance

Trail-blazing inventions in transport (steamships, railways) created risks requiring insurance in new dimensions. Without a sophisticated system of direct insurance and reinsurance, it would not have been possible to cover all these new risks. This fact, too, fostered the establishment of the first professional reinsurers. Initially these were subsidiaries of direct insurers.

The first reinsurance subsidiary was set up by a marine insurer: the "Niederrheinische Güter-Assekuranz-Gesellschaft" in Wesel, a mutual insurance company that converted to a joint stock company in 1842. In 1853, the "Aachener Rückversicherungsgesellschaft" was founded as a subsidiary of the "Aachener und Münchner Feuer-Versicherungsgesellschaft" which, since being bought out by the US Employers' reinsurance corporation, now belongs to GE Frankona Re. The world's first stand-alone reinsurance company, the "Kölnische Rückversicherungs-Gesellschaft" was founded as a joint stock company in 1843 in response to the "Great Fire of Hamburg" in 1842. A majority shareholding of the US reinsurance company General Re since 1994, the company operated under the name of General-Cologne Re for a few years as of 2000 and now calls itself GenRe. Both companies have belonged to the Berkshire Hathaway group for some years now. In other countries, the evolution of the reinsurance sector could not keep up with the pace set in Germany. The first specialised reinsurance company founded in any other country was the "Schweizerische Rückversicherungsgesellschaft", or else "Schweizer Rück" for short, established in Zürich in 1863. The company was formed from a merger between the "Allgemeine Versicherungsgesellschaft Helvetia" in St Gallen, the "Schweizerische Kreditanstalt" and the "Basler Handelsbank". Since the Swiss market offered only limited business opportunities, "Schweizer

[22] Schwepcke (2004), pp. 3–4.

Rück" (Swiss Re) soon began to establish business relationships abroad. In the following years, further professional reinsurers emerged in France and Austria.

In the UK and the US, professional reinsurance companies did not emerge until after 1900. However, most of the demand for reinsurance in these markets was already being satisfied above all by Lloyd's, the insurance exchange that had evolved out of Edward Lloyd's coffee shop, and the so-called "fringe market". This consisted mainly of branch offices of local direct insurers set up "on the fringe of Lloyd's".[23]

1.2.2.3 From the Imperialism Era to Modern Times

1.2.2.3.1 The Imperial Age

The imperial age was marked by steady growth in world trade and aspirations to autarchy on the part of the powers involved in global politics. The insurance industry could not avoid being caught up in this development. Exchanging goods and services between spheres of interest was a risky business. It happened, but nobody wanted to have to rely on it. The (re)insurance industry in Central Europe was geared towards the continent, and especially towards the East. British markets serviced the entire Empire and the English-language regions of North America. France had its own colonies as its market.

In 1871, Lloyd's achieved recognition as a Corporation ("Corporation of Lloyd's"). In many ways, the coffee-shop meeting place had evolved into a unique institution that, even today, can claim to be a global player in many fields (not just reinsurance). Lloyd's is an association of independent insurers, until recently limited to private persons that contract insurance deals of all kinds by means of an exchange system. The London "fringe market" around Lloyd's likewise flourished during the colonial period. London commanded a leading role, both in the English-speaking world and also in certain lines of business, especially in marine insurance. In this global context, it was often necessary to offer reinsurance. By the late 1870s there were already 15 professional reinsurers in Germany.

In 1880 the "Münchner Rückversicherungsgesellschaft", "Münchner Rück" for short, was founded. The company's declared aim was to engage in international reinsurance business. The company opened up a branch office in London as early as in 1890, and shortly afterwards a major office in New York. Münchner Rück (Munich Re) was also involved in setting up a number of direct insurers such as Allianz Aktiengesellschaft in 1890.

In 1886, the "Badische Rück- und Mitversicherungsgesellschaft" was set up in Mannheim. After relocating to Frankfurt in 1907, the company was renamed "Frankona Rück- und Mitversicherungsgesellschaft". It was acquired by the Employers Reinsurance Company in 1995 and today operates under the name of

[23] Schwepcke (2004), p. 4.

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