Principles of Reinsurance Contract Law: The Reinsurer's Perspective

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Abstract

The global economic impact of reinsurance has increased significantly in recent years, leading to a desire for more certainty in the legal interpretation of reinsurance contracts as the number of disputes increases. Reinsurance contract wordings are not regulated by any overarching statutory law or regulations, in part due to the transnational nature of most reinsurance business. Additionally, reinsurance contracts have historically been interpreted by applying only general principles of contract law and good faith obligations with a heavy emphasis on the parties practice, usage and custom. This has led to significant uncertainty with respect to reinsurance disputes. The Principles of Reinsurance Contract Law (PRICL), published in 2019, aim to bring certainty to reinsurance contracts by improving wordings and developing widely accepted rules of interpretation.

I. Introduction

The economic impact of reinsurance is significant. In 2017, the premiums generated for the 40 biggest reinsurers totalled US $232 billion, whereas the sum was US $148 billion 10 years ago.[1] The losses paid out by reinsurers for catastrophic losses amounted to US $240 billion in 2017 and 2018 alone.[2] It is no wonder that the Organisation for Economic Co-operation and Development has identified reinsurance as an instrument to foster risk management and to reduce economic disruption in the aftermath of catastrophic events.[3]

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1 Intelligent Insurer, 'S&P Global Reinsurance Highlights 2018' <https://www.spratings.com/documents/20184/1581657/Global+Reinsurance+Highlights+2018/98dc8810-eead-8ff0-3f07-9889caaab0b0> accessed 20 April 2020, 14.

2 AON, 'Reinsurance Market Outlook' (April 2019) <http://thoughtleadership.aonbenfield.com/Documents/20190403-ab-analytics-rmo-april-2019.pdf> accessed 20 April 2020, 3.

3 Organisation for Economic Co-operation and Development, 'The Contribution of Reinsurance Markets to Managing Catastrophe Risk' (2018) <www.oecd.org/finance/the-contribution-of-reinsurance-markets-to-managing-catastrophe-risk.pdf> accessed 20 April 2020, 63, 66.

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Unif. L. Rev., Vol. 25, 2020, 57–66
doi:10.1093/ulr/unaa004
Advance Access Publication Date: 23 May 2020

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Considering that the reinsurance industry deals with the largest catastrophes worldwide and manages billions of US dollars in reserves and assets, it might come as a surprise that the relationship between insurer and reinsurer is mostly not determined by a specific set of statutory laws or regulations.[4] Reference is often made to general principles of contract law and also to the custom and practice adopted by the parties. Another special feature lies in the nature of the reinsurance business model. Nearly all relevant reinsurers have international business operations and reinsure risks all over the world—often without knowing which jurisdictions and legal complexities might be involved.[5]

Even if a business model is based on transnational contracts, the applicable law will only be relevant when losses occur and the parties cannot agree on the issue of how to settle them. Then, both parties will face the situation that a specific national jurisdiction is decisive with regard to the law, the contract, and the proper way to solve the dispute.

It is even more interesting that there is an attitude in reinsurance practice of not being bound by law but, rather, interpreting the contract as an 'honourable engagement' reflected in reinsurance customs.[6] This is the case, in particular, when there are arbitration clauses that oblige arbitrators to make decisions based upon customs and the commercial intentions of the parties rather than according to the applicable law.[7] The result is clearly a lack of legal clarity, which has the interesting effect that the parties usually try to avoid legal disputes and tend to find commercial solutions as an 'amicable settlement' based on a long-standing relationship. But the economic reality has changed. The decisive question is whether certainty can be achieved without giving up commercial pragmatism.

Bearing in mind this economic background, the following article does not provide an introduction to reinsurance law but, instead, deals with the importance of a new approach taken by the academic project group that has drafted the Principles of Reinsurance Contract Law (PRICL), published in 2019.

II. The purpose of reinsurance and its relevance in relation to legal certainty

The need for legal certainty is connected to the purpose of reinsurance. Insurers buy reinsurance for several reasons.[8] The essential function is probably to

[4] Kevin Bork and Manfred Wandt, 'Der moderne Guidon de la Mer: die Principles of Reinsurance Contract Law (PRICL)', VersR 2019, 1113, 1114.

[5] Dirk Looschelders in Dieter Lüer and Andreas Schwepcke, *Rückversicherungsrecht* (Beck 2013) § 9, para. 1, 414.

[6] Klaus Gerathewohl, *Rückversicherung – Grundlagen und Praxis*, vol. I (VVW GmbH 1976) 594.

[7] Gerathewohl (n 6) 594.

[8] Munich Re, 'Reinsurance: A Basic Guide to Facultative and Treaty Reinsurance', available at <https://www.academia.edu/34789657/re_at_BULLETin_at_BULLETsur_at_BULLETance_a_Basic_Guide_to_Facultative_and_Treaty_reinsurance_ii_MunicH_re_re_at_BULLETin_at_BULLETsur_at_BULLETance_a_Basic_Guide_To_Facultative_and_Treaty_reinsurance_introduction_1> accessed 8 November 2019, 3.

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protect against an accumulation of losses, mainly from catastrophes. With reinsurance, an insurer is able to reduce its general exposure and liabilities incurred. Reinsurance also allows for risk to be spread more broadly. In addition to this relief function, insurers can enhance their capacity with reinsurance—namely, they are able to underwrite more risks and new types of risks. In this context, reinsurance helps insurers to stabilize their financial results. Furthermore, the partnership between reinsurer and insurer can open up new business opportunities with the consulting services of a reinsurer—for example, in terms of new markets or lines of business, actuarial, underwriting, or claims services.

Based on the expected purpose of reinsurance, an insurer can decide whether it needs treaty or facultative cover.[9] This predetermines the contractual relationship and its terms. Facultative reinsurance concerns individual risks. A reinsurer selects the risk and accepts or rejects each risk based on the information provided by the respective insurer. The terms are focused on the risk, and a reinsurer usually needs specific primary insurance expertise to manage the exposure. For an insurer, facultative protection is a short-term need. An insurer is normally not bound to present the next risk to the reinsurer again. It can also use facultative reinsurance to protect its reinsurance treaty.

By contrast, treaty reinsurance does not allow for individual risk acceptance by a reinsurer. This contract type is intended to form part of a longer relationship and can result in a kind of 'risk partnership' if both parties recognize the benefits of a longer profitable perspective.

The parties may then choose between different reinsurance structures—usually between the underwriting of risks *pro rata* or on an excess-of-loss basis.[10] Again, the reinsurance purpose is crucial to the specific reinsurance contract. *Pro rata* or proportional reinsurance provides for a sharing of the premiums, which gives a benefit in a profitable line of business, but it also leads to a sharing of losses, which might be good protection against frequent and severe losses. It is easy to administer, and, if necessary, an insurer may use this form to recover on even smaller losses.

Excess of loss or non-proportional reinsurance allows insurers to retain more of the net premium. Consequently, an insurer will only be indemnified against a certain amount of loss in excess of a specified retention. This structure also provides good protection against frequency and severity exposure. It is also usually more economical for insurers in terms of the premium to be paid.

Depending on the view of the risks to be covered, the general risk appetite, and the common definition of the relationship, an insurer and reinsurer can agree on the scope of cover, the pricing, and the terms. If both parties have the same understanding, the settlement of losses should also be managed in the essential terms of the agreement. However, a reinsurance claim is always the

[9] Munich Re (n 8) 5.
[10] Munich Re (n 8) 8, 10.

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litmus test for the contract. The first part of the test is correctly ascertaining the facts and circumstances of the loss. The parties might have an idea of the risk and could have quantified the loss potential of that risk beforehand. An actual loss determines the risk in a final way.

There are often different views with regard to the existence and interpretation of facts. However, if the facts and circumstances that caused the loss are known and not disputed, the contract should answer the question as to whether the loss was reinsured and can be paid out or not. If both parties have indisputably agreed on the terms and whether they will be based on custom, a short slip, or a comprehensive wording, it should not be too difficult to come to a result, and legal certainty of the contract should not be an issue. Nevertheless, the claims situation will often reveal either the weakness or the strength of a certain practice or wording.

Legal certainty always depends on the approach taken by the parties themselves, especially their intentions. However, the written contract terms are not always regarded as the entire agreement: reinsurance custom and practice are taken into consideration in order to understand the intention behind the agreement, especially if there are also ambiguities in the wording.[11]

The concept of utmost good faith is often seen as the last resort to find a solution. Utmost good faith is a concept that is of enormous historical importance in reinsurance, especially as a key legal determinant. It is not a concept that constitutes the legal relationship, but it rules over the actions of the parties, and, in a way, it protects established expectations and experiences rather than the specific wording.[12]

In the early days of reinsurance—especially in the Lloyd's market—the wording was not as important as the principles of trust, transparency, and reliability, which were found in long-term partnerships.[13] The principle of utmost good faith has developed from these beginnings into a uniform principle of reinsurance. Utmost good faith has always been seen as a market-based counterbalance to the parties' interests. Economically, it has also contributed to a reduction in transactional costs, as the reinsurer can rely on the insurers being closer to the risk and, therefore, refraining from investing in additional assessment and investigation costs.[14]

However, changed economic parameters (for example, the situation during the liability crisis in the USA in the 1980s or increased financial burdens due to natural catastrophes) have also resulted in a weakening of the idea of long-term partnerships in reinsurance. Even though reinsurance as a 'people's business' always established close relationships, the idea of an honourable gentleman's

[11] Eugene Wollan, *Handbook of Reinsurance Law* (Aspen Law 2002) § 2.01 (A) –(D).

[12] Steven W Thomas, 'Utmost Good Faith in Reinsurance: A Tradition in Need of Adjustment' 41 Duke Law Journal 1548–97 (1992) <https://scholarship.law.duke.edu/dlj/vol41/iss6/7> accessed 20 April 2020, 1551.

[13] Thomas (n 12) 1556.

[14] Thomas (n 12) 1558.

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agreement did not survive if losses were incurred to an extent that did not realistically allow for the expected payback in the future.

In consequence, reinsurance relationships became more opportunistic, and disputes found their way into the courts and arbitration more frequently.[15] With an increase in legal decisions, the focus of ascertaining legal certainty shifted from the agreement between the parties towards juridification by English and US courts. The reaction from the industry was, again, to try to draft new clauses to adapt to the court decisions. However, the quality of wording did not improve, and clarity was often not the leading principle. In fact, an English judge described some of the wordings as a 'dog's breakfast'.[16]

III. Sources of reinsurance law and attempts to secure a unified approach

Reinsurance as a contract type goes back a long way.[17] The first documented reinsurance treaties date back to the 14th and 15th centuries, where they were mainly used for marine and transport. The Lloyd's market developed later. After some catastrophic fires in the 19th century, accumulation of risk became an issue that led to the foundation of several reinsurers.

Despite that tradition, the reality of reinsurance is characterized by a lack of statutory law. Unlike primary insurance, reinsurance law is mainly seen as merchant or customary law. Therefore, written contracts were often limited to some essential terms. Reinsurance law was often truly transnational law that was orientated to the usage in the marketplace. In that context, the London market stood out and developed rules that were adopted by English jurisprudence. These decisions influenced wordings over decades, but they are more often quoted in disputes and used less frequently as a guide for drafting comprehensive and functioning wordings. Even today, Lloyd's and its legal library has an enormous influence regarding the selection of certain clauses and the establishment of legal certainty and the clarity of wording.

The same rules of interpretation applying to contract law also apply to reinsurance law. However, there are two aspects in the sources of reinsurance law that are often seen as a starting point in solving transnational disputes concerning reinsurance contracts. These are the aspect of 'good faith'[18] and that of 'practice, usage and custom'. Both aspects are found in common law and civil

[15] Thomas (n 12) 1552.

[16] Helmut Heiss, 'From Contract Certainty to Legal Certainty for Reinsurance Transactions: The Principles of Reinsurance Contract Law (PRICL)' (2018) 64 Scandinavian Studies in Law 92, 94.

[17] Klaus Gerathewohl, *Rückversicherung – Grundlagen und Praxis*, vol. II (VVW GmbH 1979) 697 ff.

[18] Jeffrey W Stempel in Helmut Heiss, Martin Schauer and Manfred Wandt, *Principles of Reinsurance Contract Law (PRICL)* (2019) <https://www.ius.uzh.ch/de/research/projects/pricl.html> accessed 20 April 2020, Article 2.1.2 C1ff.

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law jurisdictions, but, despite their importance, they are interpreted very differently.

Good faith in the civil law tradition is a general principle that is also applied to reinsurance contracts, but not in the sense of a statutory basis for claims. In this context, the good faith principle is not so much the basis of the contract but, rather, is considered a general, but very important, rule of fair behaviour governing the relationship between the parties.[19] In reinsurance practice, this rule has been taken very seriously and is normally incorporated into every reinsurance contract. Even in relation to arbitration clauses, it is advised not to just follow the formal statutory law but also to apply equity and fairness and the characteristics of customary practice and usage in the light of good faith.[20]

On the other hand, the common law tradition established the legal doctrine of *uberrima fides* or utmost good faith very early on—with the famous words of Lord Mansfield in *Carter v Boehm*[21] setting the fundamental basis for every reinsurance contract, which are still valid today.

In the USA, utmost good faith has always been seen as the prominent feature of reinsurance contracts, which qualifies such contracts as implied relationships of trust.[22] In English reinsurance law, the utmost good faith principle is mainly limited to the initiation phase of the contract. While there is an assumption of a continuing duty, its application is limited by English courts.[23]

Unlike the common law tradition, the issue of custom plays a more central role in the concept of reinsurance in civil law jurisdictions. The terms 'usance' and 'custom' are often used as synonyms in practice. In civil law jurisdictions, they have the function of constituting essential elements of the contract that do not need to be agreed expressly. This includes, in particular, the duty to follow the settlements, the duty to follow the fortunes, the duty to disclose material facts, and the prohibition of misrepresentation.

The common law does not acknowledge the normative validity of custom. Custom cannot form the basis of an entire reinsurance contract or an implied agreement.[24] In this context, it is the prevailing opinion of courts in the United Kingdom and the USA that the wording of a contract comes first, and custom cannot change the clear meaning of a wording.[25] However, custom is taken into consideration as a form of evidence for a certain interpretation of the wording, in addition to its use in explaining technical and ambiguous terms.[26]

[19] Sieglinde Cannawurf and Andreas Schwepcke in Dieter Lüer and Andreas Schwepcke, *Rückversicherungsrecht* (Beck 2013) § 8, para. 49, 264.

[20] Gerathewohl (n 6) 459.

[21] *Carter* v *Boehm*, 3 Burr 1905 1909 (1766).

[22] Cannawurf and Schwepcke (n 19) § 8, para. 52, 265.

[23] John Butler and Robert Merkin, *Reinsurance Law* (Sweet & Maxwell 2011) A 0558, 0545 ff.

[24] Butler and Merkin (n 23) B-0232.

[25] Butler and Merkin (n 23) B-0232.

[26] Butler and Merkin (n 23) B-0232.

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As reinsurance and insurance have a long and economically valuable tradition, it is likely unsurprising that there have been attempts to make the national laws more compatible. The first attempts to unify insurance and reinsurance law were undertaken by the International Institute for the Unification of Private Law (UNIDROIT) in 1935–6.[27] Due to political developments in the run-up to World War II, that project was, unfortunately, lost in the mists of time. However, with the new PRICL initiative that was started in 2016, and the presentation given by reinsurance and insurance practitioners at UNIDROIT in May 2019,[28] the project has been relaunched with greater verve.

The initiators of the PRICL Project view themselves as following the tradition of the Restatements of the American Law Institute in order to compare, clarify, and draft harmonized general principles of reinsurance law from both common law and civil law jurisdictions.[29] As the PRICL Project Group is working in co-operation with UNIDROIT, it is natural that a reference to general contract law was explicitly made to the Principles of International Commercial Contracts (PICC), which have been developed by UNIDROIT.

IV. Balancing the interests of insurers and reinsurers

The interests of an insurer and a reinsurer are often parallel when it comes to covering certain exposures. The parties agree on the risk to be covered and strive for a congruency of cover.[30] In practice, the vast majority of claims will usually be settled in unanimity between the parties. The insurer expects that those claims it cannot defend will be paid out under its reinsurance cover, and the reinsurer expects that these claims will only be paid if they are, indeed, covered and could not have been avoided by the insurer. However, when a loss occurs, legal congruency does not arise automatically. Instead, the issue is whether the independent reinsurance contract is implicitly linked to the fate of the insurance contract with respect to the principles of follow the settlements and follow the fortunes and, of course, in the light of utmost good faith.[31]

The relationship between the insurer and the reinsurer is often seen as being afflicted by the problem of asymmetric information.[32] This refers mainly to

[27] Massimo Pilotti, 'Activity of the International Institute for the Unification of Private Law' in International Institute for the Unification of Private Law, *L'Unification du Droit* (UNIDROIT 1948) 49.

[28] UNIDROIT, 'International Commercial Contracts – Formulation of Principles of Reinsurance Contracts' (C.D. (98) 7) (Governing Council, 98th session, 8–10 May 2019) <https://www.unidroit.org/english/governments/councildocuments/2019session/cd-98-07-e.pdf> accessed 20 April 2020.

[29] Helmut Heiss, 'Introduction' in in Helmut Heiss, Martin Schauer and Manfred Wandt, *Principles of Reinsurance Contract Law (PRICL)* (2019) <https://www.ius.uzh.ch/de/research/projects/pricl.html> accessed 20 April 2020, 1.

[30] Eberhard Witthoff in Dieter Lüer and Andreas Schwepcke, *Rückversicherungsrecht* (Beck 2013) § 15, para. 12, 634.

[31] Witthoff (n 29) § 15, para. 47, 643.

[32] Hansjörg Albrecher, 'Asymmetric Information and Insurance' <http://pdfs.semanticscholar.org/d1c0/c6b839c45510aaa6af06d2c799d2510bcb5c.pdf> accessed 20 April 2020, 2f.

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questions of moral hazard and adverse risk selection that arise when the insurer has an information advantage, as it is normally closer to the risk.[33] From the perspective of a reinsurer, the lack of information can be addressed by increased monitoring activities and pricing adjustments. In claims especially, the reinsurer relies on the ultimate approach to calculate the losses. This means that the reinsurer has an ultimate orientation in claims (that is, it sees the incurred only as the basis, which can vary or increase over the timeline), whereas the insurer sees claims from an incurred perspective (which comprises paid losses plus those losses that have occurred, but that are still outstanding). Based on its exposure and bearing in mind the limited amount of information (for example, after a big natural catastrophe), the reinsurer could complement the insurer's incurred losses by using modelling and scenario data to come to an ultimate figure that anticipates unknown losses or increases of known losses beyond the incurred, provided that this is reasonably to be expected.

Besides the monitoring and evaluation of losses by the reinsurer itself, the relationship is, in fact, determined by the principle of utmost good faith, which acts as a framework model for balancing the interests of the insurer and reinsurer based on situational circumstances. The reference to utmost good faith is often connected with the non-disclosure and the misrepresentation of facts. In addition, this principle also governs honest and reasonable conduct in the contractual relationship. The doctrine of utmost good faith, therefore, is a kind of ethical test that will be applied in every potential dispute.

The last aspect of the analysis of the parties' interests refers to the concept of prudency.[34] Often, judgments and legal commentators refer to the prudent reinsurer, who may not act naively and who may not ignore known circumstances that influence its decision about cover. Prudency is relevant in having recourse to remedies and objections. It is also an important factor in the assessment of the 'materiality' of facts. When it comes to the settlement of claims, the prudency test is also applied to the insurer. The insurer must act as if it is not reinsured so that the reinsurer is not bound by imprudent settlements. For this reason, the prudence principle represents an additional standard to balance the interests of the parties. However, doctrines like good faith and prudence, as open legal concepts, imply uncertainty. Judges can usually refer to the common standards of their own jurisdiction and the legal commentaries that have formed these concepts over decades or even centuries. Without a transnational basis, it falls to the competent jurisdiction to decide upon the intentions and behaviour of the parties, whereas a transnational approach would have the authority to be seen as the agreed basis of the parties beyond any rules on conflict of laws and international jurisdiction.

[33] Jian Wen, 'Essays on Adverse Selection and Moral Hazard in Insurance Market' (Dissertation, Georgia State University 2010) <http://scholarworks.gsu.edu/rmi_diss/25> accessed 20 April 2020.

[34] Butler and Merkin (n 23) A-0586.

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V. PRICL (principles of reinsurance contract law) as a contribution towards clarity in reinsurance law

The dependability of the legal background can be a problem in reinsurance. The answer to whether a clear legal basis for resolving conflicts exists largely depends on the chosen venue. If the applicable law is that of an important market, such as the United Kingdom, or the law of certain US states, the existing case law will usually provide a good basis for a judgment. However, in international reinsurance, the parties often opt to apply the law of the cedant's home jurisdiction, which usually does not provide any indication of how the case will be considered legally. Furthermore, referring to customary commercial practices in reinsurance helps little in this regard.

Now, for the first time, the PRICL Project Group is making it possible to create a kind of transnational reinsurance law. The PRICL's initiators do not see them as a set of harmonizing standards to be ratified at the national level. On the contrary, they are to have 'soft law' status and mainly offer the option of defining the legal principles applicable to a contractual relationship, via a corresponding stipulation. As a result, the PRICL will play a dual role in satisfying calls for legal certainty as well as enabling legal clarity.

On the one hand, the PRICL maintain the legal tradition of taking into account both sector-specific commercial practices and the principle of utmost good faith. On the other hand, a review of the current provisions shows that many individual questions have already been covered and, more importantly, that they aim to achieve a fair balance between the reinsurer's and the primary insurer's interests. From a practitioner's perspective, it should pointed out that the PRICL can be applied flexibly—that is, the individual provisions may, of course, be adjusted in keeping with the freedom of contract. However, given the rules' cross-references and structure, it would appear sensible to apply them as a whole.

Of course, from a national law perspective, the objection remains that soft law cannot be enforced in the same way as the respective country's actual legislation. In addition, conflicts of interpretation between the parties in the respective jurisdiction are always possible. Nevertheless, these ostensible disadvantages are more than offset by a series of advantages.

In practice, it is important to note that the current rules are not carved in stone. The PRICL can be expanded and supplemented as appropriate through comments and negotiation between the primary insurer and the reinsurer. At least the acceptance of the PRICL as a new set of rules remains open. It will be up to the practice of reinsurers and insurers as to whether they will start incorporating the PRICL in their day-to-day business.

Above all, the PRICL will be of aid to any party in resolving a legal conflict in reinsurance. It will also particularly help with arbitration clauses that are unclear about whose laws apply. Finally, the PRICL will improve the quality of documentation. It is possible that the PRICL will not be particularly relevant to long-standing customer relationships. Nevertheless, the increasing number of run-off

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cases shows that legal disputes between primary insurers and reinsurers are becoming considerably more public as conflicts and are less frequently characterized by commercial negotiation or compromise. It is precisely in such situations that the PRICL can be of great help.

Despite being in its initial phase, the PRICL Project will surely be as significant and worthy of recognition as the Contract Certainty Initiative several years ago. Indeed, the wording of reinsurance agreements is often considered to be less relevant than pricing only and, unfortunately, is very often seen as a target for pricing concessions (for example, through phrasing that specifically serves to expand cover for the same or even a lower rate). Reinsurance litigation before the courts and arbitrators remains a risky adventure time and again. As a result, improved wording thanks to the PRICL, and broader acceptance across the industry, would play a key role in advancing reinsurance.

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