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Reinsurance Dialogue

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Reinsurance Dialogue

between

Christopher J. Robey

and

David E. Wilmot*

September 6, 1994

Re: The Arbitration Clause

The Special Termination Clause

Dear Mr. Robey,

The Arbitration Clause

The Arbitration Clause has appeared in reinsurance contracts longer than any of us can remember. It still serves as a quaint reminder that we are to treat reinsurance "as an honorable engagement and not as merely a legal obligation."

This quotation is taken from an arbitration wording used in 1941, but neither the date nor its location in the contract are important. What does matter are the principles upon which insurance and reinsurance agreements are based: They are contracts of utmost good faith demanding higher levels of disclosure and cooperation than may be required in other contractual endeavors. Contracts of reinsurance are partnerships in which one party is in possession of considerably more detail than the other. Equally important, both the insurer and the reinsurer trade in the unforeseen.

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In practical terms, "unforeseen" means that no amount of word-crafting can capture every contingency. As a result, market practice and intent become integral components in the operation of insurance and reinsurance contracts. Often, reinsurance wordings will be shaped and amended by events. Those events may lead to arbitrations, which in turn, influence future wordings.

Over the years, the insurance industry has developed clauses and treaty contracts suited to its higher expectations of
512 partnership and good faith. However, because contracts are subject to Canadian law and court interpretation, those drafting these agreements have included the Arbitration Clause so that interpretation of intent will remain in the hands of insurers and reinsurers.

This deserves closer examination.

Canadian courts are not initially concerned with finding the intent of treaty wordings. When called upon to interpret a contract, the court must look to the language of the agreement and apply the rules of interpretation to determine meaning. Only when there is ambiguity in the wording will the court try to determine the *intentions* of the contracting parties at the time the contract was formed. This determination may, at the court's discretion, extend beyond the wording. Outside evidence of intent may be heard. But even at that stage, interpretation will be made by a court unfamiliar with and unaccustomed to reinsurance principles and practices.

The Arbitration Clause allows the parties (more often than not, it *requires* the parties) to address their differences in arbitration *before* proceeding to court. Inasmuch as courts will uphold the findings of a properly conducted arbitration, arbitration effectively frustrates any effort to go to court. In arbitration, the parties will not be bound by the rules of evidence; therefore, either party may introduce evidence as to the intent of the agreement – evidence that would violate the hearsay rule and would likely be excluded by a court. At the same time, the arbitration will draw on expert insurance and reinsurance

practitioners who are familiar with market practice and thus, with the intent underlying much of the phraseology used in treaty wordings. The conclusion of an arbitration will be more likely to reflect the original intent of the contracting parties.

An example may help to distinguish between the approach of a court and that of an arbitration: An agreement is reached to quota share a portfolio of automobile business, and the contract states that the treaty commission includes original commission "plus taxes and other premium charges." The reinsurer ultimately realizes that Ontario Hospital Insurance Plan assessments have not been treated as a premium charge within the commission, but as a portion of losses within the loss ratio charged to the reinsurer. In this dispute between the insurer and the reinsurer, a court might find that the wording unambiguously favours the reinsurer. An arbitration, on the other hand, would likely note that market practice supports the Cedant's position.

It is true that our industry retains imprecise and even ambiguous language as it continues to paste and boiler plate its wordings together. But, supported by intent and market practice, these surprisingly brief wordings have served us well.

Looking at the circumstances under which reinsurance is conducted, intent and market practice become even more important. As you noted, contract wordings are often produced many months after the commencement of the contract. In other words, treaty negotiations and intent may supersede the contract wording by a considerable length of time. This delay is unavoidable. Reinsurance is conducted in the flurry of a renewal season in order that hundreds of contracts may be concluded on a single date. You observed that our industry is unique in conducting its business this way, and I agree. In fact, I see it as further evidence of our respect for intent over words.

If you want the hundreds of renewing contracts completed, vetted, and signed *prior* to their inception, and if you require verbiage so comprehensive and so iron-clad that an arbitration clause is redundant, then Cedants may have to forgo any flexibility in structuring or negotiating their reinsurance

agreements, while reinsurers may have to forgo their summer vacations. Treaty wordings currently run from 10 to 20 pages in length, but a truly comprehensive wording could conceivably run to hundreds of pages, as do many construction contracts. Imagine drafting 300 treaty wordings of 100 pages each during the year-end negotiation period!

In your letter of May 24, 1994, you suggested that, now that reinsurance is "very much ... a big business" we needn't hide "behind the idea that the intent is more important than the words ..."

It has been my experience that, as some companies prosper and grow, their far-sighted approach to business favours an *increased* atmosphere of trust and good faith. (Or is it this atmosphere that causes them to prosper?) These companies know and trust, and are trusted by, their reinsurers. On the other hand, I have seen troubled insurers and reinsurers, with backs to the wall, try to enforce the letter of the treaty contract if it best serves their particular situation, while advocating treaty intent when it does not.

Ultimately, parties operating in good faith can achieve their objectives with or without the presence of an Arbitration Clause. They can mutually choose to ignore the clause and resolve disputes in some other appropriate manner, or conversely, they can choose to arbitrate even in the absence of an arbitration wording. However, when one party is no longer interested in resolving a dispute on the basis of good faith intentions, the other requires every protection possible, including the protection of an Arbitration Clause.

The Special Termination Clause

Another clause designed to protect individual treaty participants is the Special Termination Clause. This clause sets out the rights of the Cedant or the reinsurer when the circumstances of the other party change significantly. In a less sensitive time, this was referred to as the "Sudden Death" clause, and indeed, it permits termination of a reinsurance agreement

with a partner who has impaired its capital, become insolvent, or has failed to meet its obligations under the contract. Other reasons for special termination include change in ownership and actions effecting a reduction in the net retained share of business ceded to the treaty.

In most of the wordings in current use, the actual date of termination is determined by the party exercising the clause and giving notice. In recent years, this notice period has become an issue.

In the past, most wordings used in Canada called for a rapid ("forthwith") cessation of business, with no notice period whatsoever. However, such sudden termination of protection is not always practical. In the case of the insolvency of the ceding company, the interests of the original insureds must be recognized. At the very least, reinsurance must remain in place until original policies of insurance can be replaced. For this reason, at least one of the provincial offices of the Superintendents of Insurance tried its hand at re-writing the Termination Clause with the intention of providing a lengthy notice period. The wording was not adopted, but the Canadian market did move to a notice period of about one month. (The Reinsurance Research Council has not produced a recommended Special Termination Clause, but a group of reinsurers did produce an unofficial wording that also used one month as the notice period. The group felt that, in the event of an announced insolvency, brokers would be able to act quickly in replacing insurance policies.)

More recently, I have encountered clauses in which the notice requirement treats insurers and reinsurers differently. While the reinsurer must give the cedant at least 30 days notice of cancellation, the cedant can, at its option, cancel the treaty *back to the beginning of the current contract year*.

The reasoning behind this provision is not clear, but the potential for abuse is disturbing. I can only assume that those drafting this provision wanted to protect the cedant from diminished (insolvent) reinsurance on as-yet-to-be reported

claims. Before a cedant could retroactively terminate one of its reinsurers, the treaty's status would have to be considered. If one or more substantial losses had already occurred, the cedant would have little hope of transferring liability to a new reinsurer. Claims to the treaty would have to be small or unknown for the cedant to replace its protection. This means that the retiring reinsurer, who assumed liability for whatever time has elapsed, must return the reinsurance premium and go unpaid. In an extreme case, the cedant could attempt to retroactively cancel a low layer catastrophe reinsurer 10 or 11 months after January 1, and decide to keep the premium and not replace the protection because, after all, the tornado and flood season is now over.

And as opportunistic an unacceptable as this would be in the case of a troubled reinsurer, retroactive termination could be enacted for *any* of the triggers listed in the Special Termination Clause. Conceivably, the cedant could take unfair advantage of a healthy reinsurer involved in a corporate merger or purchase.

The retroactive cancellation provision has no practical purpose, but is open to misuse. For this reason, it should not be used.

This problem highlights another of my concerns regarding notice and the timing of termination: Few of the clauses in current use distinguish the relative merits or importance of the individual termination "triggers." An insurer who looses "part of its paid up capital," for example, may not be a candidate liquidation, and yet the other party can give notice as freely as if the company were already in receivership. (I saw one wording attempt to overcome this with the words "lose more than 50% of its paid-up capital," but a more effective solution might be "fail to meet the minimum asset requirement of regulatory authorities.")

You may have noted that the list of termination triggers falls into two categories, which I would described as voluntary and involuntary. Failing asset requirements, liquidation, discontinuing at the order of a regulatory authority,

are involuntary triggers, while ending one's separate existence, effecting a reduction in net retained share, or failing to meet its obligations under the Agreement are voluntary. It could be argued that an insurer or reinsurer creating a "voluntary" trigger deserves different treatment from one who has fallen into financial difficulty. In fact, commercially-minded reinsurers will generally co-operate with their cedants, regardless of the terms of a Special Termination Clause. However, if a cedant has just been purchased by an organization unfettered by social principles or honesty, reinsurers may want to depart "forthwith."

Perhaps a sub-committee of the RRC will address and attempt to standardize this clause. No doubt, your anticipated reply to this letter will give that committee even more to think about.

Yours sincerely,

David E. Wilmot