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REINSURANCE DIALOGUE

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Aller au sommaire du numéro

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REINSURANCE DIALOGUE

between Christopher J. Robey and David E. Wilmot

November 5th, 1996

Re : Price of Security
Extra Contractual Obligations
Punitive Damages

Dear Mr. Robey:

Price of Security

In your letter of February 16, 1996, you noted that each reinsurer's ability to pay losses may not be equal, particularly following a devastating national catastrophe. I can not argue with this statement. However, you go on to suggest that the terms of each reinsurer on a given treaty should vary in relation to its individual level of security (as established by some international reinsurance security rating organization). Why, after all, should weak reinsurers enjoy the same compensation as those better able to pay losses?

This suggestion represents a significant departure from traditional reinsurance practice. As you noted, the well-established principle of "most favored reinsurer" frustrates a Cedant's ability to compensate each reinsurer differently. All reinsurers expect to enjoy the same terms and conditions – even if they are not in a position to return the same level of security to the buyer.

You have identified the difficulty in measuring reinsurance security. However, even if valid assessments could be made at the outset of a catastrophe treaty, the unassailable security of every

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reinsurer can not be guaranteed throughout the life of the contract. Some of the greatest hazards to continuing security may not have been captured in a rigorous security analysis. Can international rating agencies assess the continuing security of the retrocessionaires behind a particular treaty market? Could capacity (or retrocessional capacity) be exhausted by some catastrophic event in another part of the world? Has the reinsurer correctly calculated its aggregate exposures in Canada? And have these Canadian exposures been correctly aggregated against loss outside Canada arising from the same event (a Vancouver/Seattle earthquake, for example)?

Your argument draws on the example of governments and institutions whose creditworthiness (established by the likes of S&P or Moody's) determines the interest rates at which they can borrow money. However, the comparison is not valid. Reinsurers are not borrowers who must pay back loans out of anticipated future income. They are insurers expected to make immediate loss payments out of existing capital resources. In very black and white terms, a reinsurer either does or does not have the ability to make good on its commitments. If there are doubts as to this ability, then the Cedant should shop elsewhere.

Canada is well served by a number of strong reinsurance markets, able to accommodate most capacity needs. Where greater capacity is required – generally for the largest catastrophic exposures – then the need for caution in selecting security probably increases. It would make little sense to purchase questionable, albeit discounted, security if the hapless insurer suspects the cupboard could be empty on the occasion of its greatest need. How remarkable to accept capacity that has the greatest chance of failing under the very situation for which it was purchased!

In your letter, you quote the familiar adage "Weak capacity is better than no capacity at all." This solution belongs to those who would fool their shareholders, the regulators and themselves. I am inclined to compare this approach to buying a broken umbrella in the expectation that it will never rain.

You also argue that Cedants can afford to be less concerned with the long-term security of catastrophe reinsurers due to the short-tail nature of catastrophic losses. Again, I must disagree. Because catastrophe treaties represent "banks" of premiums against future loss, the selection of a secure catastrophe reinsurer should be seen as an equally long-term consideration.

There are other reasons to avoid the weighting of price-for-security in the completion of reinsurance programs, even if the

Cedant is not about to buy economy-grade capacity. One immediate problem is the complexity of assigning reinsurance shares by price versus security. Treaty negotiations, already a time-consuming process at a difficult time of year, would degenerate into Byzantine calculations on the relative merits of quoting reinsurers. Nor would the regulators care to see weak, troubled or mismanaged insurers weigh the cost of reinsurance over the security of the capacity purchased.

What I cannot disagree with is your disturbing observation that strong security is seen as nothing more than "curb appeal [as in] a house for sale."

I trust no one would buy a house with substantial liens against it! The fact that the house is unencumbered represents more than "curb appeal." Why then do insurers – professionals in the financial sector – treat secure capacity as little more than curb appeal? Secure capacity should be nothing less than the raison d'être behind the larger catastrophe programs.

Extra Contractual Obligations

I will now turn to the subject of Extra Contractual Obligations (ECO), because recent events suggest the need for a Canadian perspective on this often-misunderstood clause.

The ECO Clause is closely associated with the Excess of Policy Limits (XPL) Clause, so I should take a moment to compare and distinguish the two. The XPL or Excess of Policy Limits Clause is widely used in Canadian property and casualty excess of loss treaties, principally to address the danger of first party bad faith claims from the Cedant's insureds due to the mishandling of third party actions on their insured's behalf. The clause covers claims against an insured for which the Cedant is legally liable, over and above the original policy limit, due to a) a minimum statutory limit, b) failure by the company to settle a claim within the policy limit, or c) alleged or actual negligence in rejecting an offer of settlement, or in the preparation or conduct of the defense in any suit (including subsequent appeal) brought against the insured.

The clause brings into the treaty a separate and otherwise unreinsured award, and effectively adds this award to the original claim for the purposes of calculating the treaty's ultimate net loss. Although this clause results in additional treaty exposure, excess of loss reinsurers have tended to accept the XPL Clause on the principle that such unfortunate awards arise out of the Cedant's best efforts to control the cost of the claim on the reinsurers' behalf as well as its own.

The clause recognizes the entire award in the calculation of the ultimate net loss. Punitive damages against the Cedant are excluded by the clause, as are losses arising from the Cedant's self-insured obligations, if any, or from loss incurred due to fraudulent acts by the Cedant's staff or board members.

The ECO or Extra Contractual Obligations Clause, despite similar wording, is quite different. Inasmuch as it commits the reinsurers to provide a degree of errors and omissions coverage to the Cedant, it can almost be viewed as direct insurance. The clause assumes liabilities against the Cedant not covered elsewhere in the treaty, which arise from the handling of claims on the business covered because of, but not limited to, a) minimum statutory limit, b) failure by the company to settle a claim within the policy limit, or c) alleged or actual negligence in rejecting an offer of settlement, or in the preparation or conduct of the defense in any suit brought against the insured (including subsequent appeal).

The clause includes a co-insurance feature and may invoke an additional, separate reinsurance charge. Traditionally, 80% of the award against the Cedant is included in the ultimate net loss calculation. Again, punitive damages against the Cedant are excluded by the clause, as are losses arising from the Cedant's self-insured obligations, if any, or from loss incurred due to fraudulent acts by the Cedant's staff or board members.

In summary: XPL assumes 100% of awards against the insured which, due to a bad faith action, become payable by the insurer. ECO assumes (usually) 80% of awards against the Cedant arising out of the handling of claims on the business covered. Other exclusions and limitations are similar if not identical.

In Canadian usage, an ECO clause will invariably appear in conjunction with the XPL Clause. ECO is actually broad enough to encompass the subject matter of the XPL Clause, but the use of both clauses serves to reinsure XPL awards on a 100% rather than an 80% basis.

The Reinsurance Research Council produced a recommended wording for the XPL Clause in October of 1984, but declined to endorse an ECO Clause at that time, because it was seen as a primary errors and omissions policy. I don't know if the RRC would react any differently today, but I do believe that reinsurers must work with and be supportive of Cedant claims control measures

– even if there are occasional, reinsured, repercussions from time to time.

Insurance fraud initiatives are encouraging insurers to take increasingly aggressive measures in their claims handling. Both Cedants and reinsurers must become increasingly mindful of bad faith actions, while recognizing that, ultimately, everyone's best interests will be served by the initiative. Fortunately, insurers are taking sensible measures that may actually reduce the possibility of awards under the XPL Clause and the ECO clause. An increasing number of claims departments are establishing SIUs or Special Investigative Units to investigate questionable claims – often hiring former police officers who are experienced investigators with impressive connections. A police officer's predisposition to seek out guilt may have to be checked, but rapid and effective use of SIUs should permit the insurer either to clear and pay a claim quickly or to reject the claim on the basis of sound evidence.

Punitive Damages

Extra contractual obligations, then, include such things as awards in excess of policy limits and other legal actions against the Cedant arising out of its claims-handling activities. In the United States, ECO includes punitive damages awarded against the Cedant (in states where permitted). Indeed, punitive damages represent the greatest exposure to the clause in that country. However, punitive damages against the Cedant are not covered by Canadian ECO wordings. To understand why this is so, we can tum to Canadian jurisprudence.

The historical development of punitive damages in Canada stems from our underlying conservatism in approach to the law – a conservatism that is arguably missing from American courts. In Canada, civil actions seek to compensate rather than punish. Until recently, punitive damages were not available in contract disputes, and were, most often, reserved for personal injury claims such as libel and slander, where compensation requires an element of sanction in order to right the wrong.

In Canada, most civil actions are decided by a judge rather than a jury (perhaps due to the tendency for Canadian juries to make relatively conservative awards). The reverse is true in the United States, where juries seem to have adopted the role of regulator/watch dog on corporate behavior. In that country, it is not uncommon to see punitive damage awards reach into the tens or hundreds of millions of dollars.

More importantly, in dealing with insurance companies, Canadian courts have access to the remedy of bad faith which has come to be recognized as a separate head of damages (that is, separate from normal compensatory damages or punitive damages). Damages for bad faith will tend to arise out of third party situations in which the insurer has handed the claim in such a way as to expose its own insured to a civil judgment in excess of policy limits. The availability of this remedy has forestalled the use of punitive damages against Canadian insurers. As stated earlier, bad faith awards are recognized by the XPL clause.

Awards of punitive damages are more likely to arise out of a first party situation as the result of a dispute between the insurer and its own insured. However, one must appreciate how difficult it is for Canadian insurers to provoke such an award. The insurer's approach to the claim must to go beyond aggressive claims-handing, such as the delay of settlement in order to conduct a rigorous investigation. (See The Insurance Company's Right to be Wrong in the July 1993 issue of this publication). It would likely have to go beyond a bad faith action arising out of the insurer's disregard for the validity of a submitted claim. Here, the insurer may face aggravated damages. However, even these must be awarded on the basis of real damage such as mental distress and anguish or costly inconvenience. For this reason, aggravated damages are considered compensatory rather than punitive. In order to bring punitive damages upon itself in a Canadian court, the insurer's actions must be so willfully and wantonly reprehensible as to stir in the court the need to punish the conduct of the insurer, or to set an example, or both.

It follows that, in Canada at least, punitive and exemplary damages against the insurer do not belong in the reinsurance contract. Unlike the situation in the United States, such damages are likely to be the result of Cedant conduct far outside reasonable and acceptable claims procedure. Equally important (though not firmly entrenched in Canadian jurisprudence), it is not in the public interest to allow the insurer to "dodge" punitive or exemplary awards by simply passing them on to reinsurers.

Not surprisingly, Canadian insurers have little experience upon which to draw. There have been only two instances of punitive damages against Canadian property and casualty insurers to reach public attention, both involving first party homeowners or tenants property policies. One case arose a number of years ago when a relatively small sum was awarded for the purportedly abusive behavior of the insurer's representative. The second case took place in early 1996, and represents something of an escalation in quantum.

A Canadian insurer was hit with a $1-million punitive damages award as a result of its prolonged denial of a house fire claim which put its insureds out on the street. The size of the award, its immediate appeal, and the surprising fact that the trial decision was not reported in the Ontario Reports (only a novel procedural point was reported, not the trial decision itself), suggests that this award does not as yet have value as a precedent.

Yours sincerely,

David E. Wilmot