Assurances

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Excess of Loss Reinsurance: Review of standard clauses (Fire and Allied Perils)

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Volume 41, Number 4, 1974

URI: https://id.erudit.org/iderudit/1103796ar
DOI: https://doi.org/10.7202/1103796ar

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Publisher(s)

HEC Montréal

ISSN

0004-6027 (print)
2817-3465 (digital)

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Cite this document

Pearce, E. (1974). Excess of Loss Reinsurance: Review of standard clauses (Fire and Allied Perils). *Assurances*, *41*(4), 275–298. https://doi.org/10.7202/1103796ar

ASSURANCES

Revue trimestrielle consacrée à l'étude théorique et pratique de l'assurance au Canada

Les articles signés n'engagent que leurs auteurs.

Prix au Canada :
L'abonnement : $4.00
Le numéro : - $1.25

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Courrier de la deuxième classe — Enregistrement N° 1638

41e année — Montréal, Janvier 1974 — N° 4

Excess of Loss Reinsurance: review of standard clauses (Fire and Allied Perils)[1]

by

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II

Article 5. Ultimate nett loss

This Article appears in most excess of loss contracts. The text may vary in detail but the following is fairly standard:

> 1. The term "ultimate nett loss" shall be understood to mean the sum or sums paid by the Company in settlement of losses for which the Company is liable after deducting all sums recoverable under other reinsurances whether recovered or not and all recoveries and salvages and shall include all expenses including legal costs incurred in the investigation settlement and adjustment of claims (other than office and salary expenses of the Company).

[1] La première partie de cette étude a paru dans le numéro d'octobre 1973 de la Revue. A.

2. Nothing however in this Article shall be construed as meaning that losses are not recoverable hereunder until the ultimate nett loss of the Company has been ascertained.

3. Recoveries and salvages recovered or received subsequent to a loss settlement under this Agreement shall be applied as if recovered or received prior to such settlement and all necessary adjustment shall be made by the parties hereto.

The main object of paragraph 1 is to establish clearly the basis to
276 be used to arrive at the amount of any loss, so that the Company and the Reinsurer may know beyond doubt what is to be included and what excluded from the statement of claim.

No doubt when the excess of loss method of reinsurance first came to be used on a wide scale, the assessment of the final cost of the claim was not an easy matter. Indeed, at a time when neither party had any great experience of this form of reinsurance, there must have been considerable difference of opinion regarding some items of expense. Such differences were presumably settled with goodwill and understanding on both sides, but it became clear that a precise definition was required.

The reference to the deduction of sums recoverable under other reinsurances is interesting. When all reinsurance was on a proportional basis, the assessment of the liability of each reinsurer was not in doubt. Each reinsurer paid the loss exactly in proportion to his share of the original policy or policies. If there was double reinsurance the position was exactly the same as if there had been double insurance. The shares were scaled down and the appropriate premium returned, the loss if any, being dealt with on the basis of corrected sums reinsured.

However, with the introduction of excess of loss reinsurance the matter became more complicated. The Company may have felt that if by design or mistake two different forms of reinsurance had been arranged, then the Company should have the right to decide under which of the two a recovery should be effected. Should the Company apply the excess of loss and protect the proportional, or apply the proportional and protect the excess of loss ?

The excess of loss Reinsurer at least was not in any doubt. His firm view was that this was merely an extension of the insurance

principle that when more than one insurance applies to a particular risk, the more specific insurance should first meet losses. The proportional was evidently the more specific reinsurance because it would meet a share of the small as well as the large losses.

However, almost any rule can be altered by prior agreement between the parties, and as the excess of loss method developed it became admitted practice that, if required, the contract should protect not only the nett retention of the Company, but also shares ceded to proportional reinsurers. The simplest example is where the Company cedes (say) 50% of each risk on a quota share basis and arranges excess of loss reinsurance for common account of the Company and the quota share reinsurers.

Excess of loss reinsurers generally, having established the principle that proportional reinsurance is the more specific reinsurance, were reluctant to do anything which would weaken this and they require that it should be clearly stated in the contract whether or not the excess of loss reinsurance is for nett account or common account. As a matter of information they may wish to know the nett retention of the Company, but this has become less and less usual in recent years.

However, when it is agreed, for example, that quota share reinsurers also are to be protected, the question arises as to how this is to be written into the contract.

One method is to include the quota share reinsurers in the definition of "Company" in the preamble to the contract. For example, "The Insurance Company of Montreal and its quota share reinsurers (hereinafter called 'the Company') on the one part".

It would then seem that no alteration would be necessary to paragraph 1 above. But is this strictly correct? The clause still refers to "sums recoverable under other reinsurances". This will now include any reinsurances arranged by the quota share reinsurers in respect of their (say) 50% share. Thus, strictly on the wording of the contract, the excess of loss reinsurer might be entitled to enquire whether the quota share reinsurer had any separate protection, and if so to require that it should inure to the benefit of the excess of loss reinsurer.

Further, the claims notification clause requires the Company to notify the claims as soon as the excess of loss reinsurer is likely to be

interested. The word "Company" now includes the quota share reinsurers, so that such duty may now devolve on them also, as indeed all other duties of the "Company" under the contract.

Furthermore, if the quota share reinsurers are included in "the Company", there might be a case for saying that there is a contract between the quota share reinsurers and the excess of loss reinsurer. If this is so, then the scope of the reinsurance, described, possibly, as covering "all insurances in respect of Fire and Allied Perils written by the Company in Canada", might extend to such business written by the
278 quota share reinsurers in the capacity of Insurers. This, probably, neither the quota share reinsurers nor the reinsurer had ever contemplated.

It seems, therefore, that the simplest and most satisfactory method of meeting this point is not to include the quota share reinsurers in the definition of "the Company" but to include in the text of paragraph 1 above, the necessary words of clarification, thus:

"— sums recoverable under other reinsurances (other than quota share reinsurances) whether —"

In this manner both parties make a declaration of their intentions as to the protection afforded by the reinsurance.

The latter part emphasises that the excess of loss reinsurance is not to be treated as a protection for the Company against the possibility of one of the quota share (or other) reinsurers being unable or unwilling to pay their share of a claim. For example, in the case of a reinsurance applying to the nett retained lines of the Company, based on a 50% retention, if the Company finds that one of its proportional reinsurers for say 20%, does not pay its share, the Company cannot merely increase the ultimate nett loss by the amount not collected and recover it from the excess of loss reinsurer.

In some contracts the text deals with this in much greater detail and spells out the position. The following is the text sometimes used:

"The Reinsurer's liability hereunder shall not be increased by the inability of the Company to collect from any other reinsurer any amount which may have become due from such other reinsurer whether such inability arises from the insolvency of such other reinsurer or otherwise."

Let us now turn to paragraph 2 of the Article quoted above, which makes it clear that the Company does not have to wait until the original

claim has been finally settled before being able to encash the Reinsurer's participation. Nevertheless. as mentioned in the notes relative to Article 3, (Deductible and Limit of Liability) the Company in the strictest sense is required to make payment before being able to obtain reimbursement from the Reinsurer.

The importance of paragraph 3 above, is that it emphasises the principle that recoveries and salvages, whensoever obtained must be applied to reduce the amount of the ultimate nett loss. At one time there was misunderstanding in this respect, particularly in those cases where it had been necessary to fight an entirely separate action to obtain from a third party reimbursement of a loss already paid. Because of the law's delays the recovery might not be made until years after a settlement between the Insured and the Company, and the corresponding settlement between the Company and the Reinsurer. It is understandable that if the Company were more accustomed to the rules of proportional reinsurance, the Company would refer to its records, see that the Reinsurer had contributed say 60% of the claim, and credit the Reinsurer with the same percentage of the amount recovered.

But this is fallacious. The recovery and the relative legal costs must be applied exactly as if the recovery had been made and the costs incurred prior to any settlement by the Reinsurer, so as to establish finally the ultimate nett loss and the Reinsurer's liability. In fact the nett recovery (that is after deduction of costs) is payable to the Reinsurer, and only after his share of the loss has been entirely reimbursed with any balance be payable to the Company.

Although the definition of ultimate nett loss quoted in paragraph 1 above, is that frequently used to-day there are two variations which may be encountered from time to time.

(a) The apportionment of costs

The clause provides that the ultimate nett loss shall exclude legal costs, provision being made for the latter to be shared between the Company and the Reinsurer in proportion to the share of each party in the loss as finally determined.

In theory this seems quite fair and reasonable, because the legal costs are incurred so as to establish the amount of the indemnity payable under the original insurance policy. If it is impossible to reach

a compromise with the insured the Company is forced to resort to legal action. Suppose that the indemnity as finally determined amounts to C$150,000 of which C$50,000 is payable by the Company and C$100,000 is payable by the Reinsurer. The costs are then payable as to one-third by the Company and two-thirds by the Reinsurer.

However, suppose that as the result of the legal action the indemnity is established at an amount within the deductible, say C$40,000. As the Reinsurer does not contribute to the indemnity, he is not required to meet any part of the costs, so that the Company may find itself in a less advantageous position than if it had merely accepted the Insured's assessment of the claim, paid its C$50,000 and left the Reinsurer to pay the remainder.

Of course, no Company would permit itself to conduct the settlement of claims in that manner, and in any case, as we have seen when considering Article 3, the Company is required to establish the amount which the Company is "liable to pay". As will be appreciated, in some cases the outcome can be very disappointing to the Company.

(b) The apportionment of interest

This is a modification of the condition referred to in section (a) above. The legal costs are included in the ultimate nett loss, but the interest on a judgment is apportioned between the Company and the Reinsurer in proportion to the share of each in the loss as finally determined. This rule is likely to be of less importance in relation to Fire claims than Casualty claims, which latter may be outstanding for many years. Nevertheless the principle is the same.

The theory is that until the claim is settled, each party has had the use of the money and has been able to invest it at a reasonable rate of interest.

Thus, if the final judgment is for C$100,000 plus interest at 7% per annum for two years, being C$14,000, the total claim is C$114,000. Assuming that the deductible is C$50,000 and that the Company and the Reinsurer have both been able to invest their outstanding claims reserve at the rate of 5% per annum, each will have earned C$5,000 during the two years.

It may seem to the Reinsurer to be unfair that the whole amount of the legal interest should be included in the ultimate nett loss, so that

the claim is C$114,000, of which C$50,000 is payable by the Company and C$64,000 is payable by the Reinsurer, whereas in fact, the Company has earned C$5,000 as investment income, which reduces its nett share to C$45,000.

Another aspect of the application of this clause is that whereas in some countries interest is always payable as a separate item calculated on the capital sum awarded, in other countries this is not necessarily so. In the latter, particularly as regards Public Liability and similar claims, the Court may award a lump sum which presumably includes an amount in respect of interest although this is not stated to be so. In such cases the Reinsurer may feel that he has been unjustly treated.

Article 6. Period of reinsurance

A typical Article is as follows:

1. This Agreement shall apply only to occurrences happening on or after the 1st January 1973 and on or before the date of termination of this Agreement.

2. The Company or the Reinsurer may terminate this Agreement by giving the other not less than three months notice of termination in writing to take effect as at the 31st December of any year. Such notice shall be given by registered post to the address of the other party as stated in this Agreement.

3. If on the date of termination of this Agreement there is in progress an occurrence or occurrences as defined in Article 4, the Reinsurer shall be liable in respect of the loss or losses arising out of such occurrence or occurrences as if the whole amount of the loss had occurred within the period of this Agreement.

There is an alternative clause, also very widely used, in which paragraphs 1 and 2 above are replaced by a text along the following lines:

This Agreement shall apply only to occurrences happening on or after the 1st January 1973 and on or before the 31st December 1973, or during any further period or periods for which this Agreement is renewed.

As will be seen, a contract subject to the first wording continues in force until one party takes the positive step of giving notice of

termination, whereas a contract subject to the second is for a fixed period and must be re-validated if it is to continue for a further period or periods.

Of recent times it has become the common practice of many Companies and Reinsurers to give notice of termination each year under most excess of loss contracts, so as to enable the responsible officers to consider the future terms and conditions and to re-negotiate as necessary.

This trend has become so customary, that in some offices the preparation and dispatch of notices of termination has become a major undertaking. Indeed, some principals feel strongly that only the paper manufacturers and the Post Office can benefit and that the sensible solution would be to use the "12 month basis" as quoted above.

Further, the form in which the notice is given may cause complications and misunderstanding. The principals may feel that merely to give a cold notice of termination is harsh and unfriendly, particularly when there is every intention of continuing the relationship. So the practice has grown up of giving "provisional" notice, which unfortunately sometimes leaves all concerned in some doubt as to the position.

Rarely, if ever, does the termination clause provide for "provisional" notice and it is difficult to see exactly how a provisional notice clause could be worded so as to give the parties any special rights or obligations which would be acceptable to both, and which they do not already have under a standard clause.

For example, when one party gives "provisional" notice, does he believe that he alone has the right to negotiate fresh terms and that at any time before the end of the year can withdraw the notice and continue as before ? It is very doubtful whether the other party would concur in such a one-sided arrangement.

Many principals, Companies and Reinsurers alike, have become so apprehensive of the dangers inherent in the practice of giving "provisional" notice that in acknowledgment of such notice they make it clear that they will become free of engagement at the expiry date of the notice, unless agreement has been reached by that date as to the terms applying thereafter.

Naturally, there is no reason why the Company should not inform the Reinsurer of the alterations which it wishes to introduce into its

reinsurance programme and to embody them in a letter sent at the appropriate time. stating that if the Reinsurer agrees, the necessary addendum will be sent, but at the same time requesting that if the Reinsurer does not agree to the alterations, he should consider the letter as being notice of termination issued in accordance with the terms of the contract.

With reference to paragraph 3 quoted above, this provides the Company with continuity of cover at the time of change over from one contract period to another. When read in conjunction with Article 4. (Each and Every Occurrence) this is a very generous concession on the part of the Reinsurer, particularly in the case where the Company has negotiated a new reinsurance elsewhere. One can readily appreciate how costly it might be for the Company if an "occurrence" were to be divided between two groups of Reinsurers or between two periods of reinsurance, because such occurrence continued beyond the year end, and so required the Company to meet the cost of two deductibles.

Practically all excess of loss reinsurance contracts relative to a class or classes of insurance (as opposed to a contract reinsuring a single policy or risk) apply on what is colloquially called the "losses occurring basis". This is a convenient way of avoiding the elaborate system, still frequently used in proportional reinsurance, of providing for the cession and withdrawal of the portfolio of unexpired risks at the commencement and termination of each contract period.

The general phrase "occurrences happening on or after the — and on or before the —" determines the exact period of reinsurance, and avoids the rather cumbersome detail quite often used, such as "commencing at 00.01 hours on 1st January" or "from midnight 1st January", phrases which may leave some doubt as to the exact period intended and which are frequent sources of error in drafting, errors so obvious as to be overlooked when the documents are being checked and signed. For instance, when exactly is "midnight 1st January"?

Attention is however drawn to the necessity for the alteration of the standard clause when dealing with specialist classes of insurance, when there may be a practical difficulty or even impossibility of fixing the date of occurrence. In such cases this Article will be adapted so that the contract will apply, for example, to "losses discovered" or "claims made against the Company" during the period of reinsurance.

Article 7. Notification of claims

The following is a simple form of this Article:

Notice of any claim or claims exceeding or which may be considered likely to exceed the deductible over which this Agreement applies shall be given by the Company to the Reinsurer as soon as the Company has reason to believe that the Reinsurer is or is likely to be financially interested in such claim or claims. The Reinsurer shall be given the opportunity of co-operating in the settlement of such claim
284 or claims.

This calls for very little comment. It is evidently in the interests of both parties that the Reinsurer should be notified with the least possible delay that a claim has arisen which may involve him.

Companies sometimes feel that they should not be required to give explicit permission for the Reinsurer to co-operate in the settlement of claims, particularly when it is recalled that most proportional reinsurance treaties state that the Company alone will proceed with the negotiation and settlement of claims.

However, it is customary for the excess of loss Reinsurer to have the right of advising the Company, and this is probably because the Reinsurer may feel that in certain circumstances, his share of the claim as finally determined, may be many times the deductible borne by the Company.

Intervention by the Reinsurer is probably extremely rare, although in a difficult case the Company is likely to ask the Reinsurer to express his views, and indeed the Reinsurer will quite often attend the Company's meetings with assessors, lawyers or accountants involved in the claim.

Certainly Reinsurers appreciate being kept informed of the progress of a claim and in particular wish to know the maximum reserve being set against each claim.

Some contracts include a clause which purports to exclude any claim not reported within a stated delay (12 months for example) of the claim becoming known to the Company.

A typical text reads: "— the Reinsurer shall not be liable for any claim of which it has not been advised by the Company before the

expiry of one year from the date upon which the Company received the first notice of any loss resulting from such claim."

It is unlikely that a Company would agree to the inclusion of such a clause in its contract, unless no other Reinsurer would offer reasonable terms for the reinsurance, but even if accepted, the clause would presumably be self-defeating, because the practical answer would be for the Company to send to the Reinsurer each year a photocopy of the Company's claims register, showing all claims notified to the Company during the year.

The notification of claims is essentially a matter of good understanding between the parties. The Company knows that the Reinsurer is anxious to be kept informed, so that the Reinsurer can maintain adequate reserves. Similarly the Reinsurer understands that claims can become more serious than was at first expected, or that by oversight the Company may omit to notify a claim.

Article 8. Settlement of losses

The following is the usual form of this Article:

1. The Reinsurer agrees to pay claims hereunder within fifteen days of receipt of proof of the loss and of the sum payable.

2. Provided always that the Reinsurer shall have the right to deduct from any payment due to the Company in respect of such loss any sum or sums due by the Company to the Reinsurer and arising out of this Agreement or out of any reinsurance or contract renewing or replacing this Agreement.

It is a little difficult to know whether these two paragraphs were originally imported into excess of loss reinsurance contracts to express formally an agreed understanding between the parties, or whether they expressed a shade of suspicion.

There is little doubt that in the early days of excess of loss reinsurance, the contracts were in many cases between principals little known to each other, particularly in the case of those Companies who had up to that time been dealing exclusively with the larger and more important professional Reinsurers, who carried such a large share of the proportional reinsurance and who refused to enter the non-proportional field until comparatively recent times.

So in some instances there may have been a feeling on the part of the Company that not having had personal experience of the Reinsurer's probity, it was a matter of common prudence to set a date upon which the Reinsurer would in honour be bound to make payment of the loss.

The Reinsurer may have felt that it was the merest justice that he should be permitted to deduct from loss settlements, amounts due to him by the Comany.

On the other hand, it may merely have been the intention to set
286 out in paragraph 1, in formal terms, the agreement by the Reinsurer to make payment within a stated time from the request being made by the Company. It will be noted that this is expressed in words almost exactly similar to those used by Insurers in their insurance policy forms, issued to their Insureds.

Paragraph 2, was possibly no more than a re-write of the accounts clause used in contracts applying to proportional reinsurances, simplified to meet the less complicated accounting processes for excess of loss reinsurance.

It is possible that the conditions stated in both these paragraphs have served a useful purpose from time to time, and they continue to appear in practically all contracts relative to this method of reinsurance.

Article 9. Rate of premium and deposit premium

There are many different forms of this Article, but the following is the basis of the text frequently used:

1. The premium payable by the Company to the Reinsurer for each year during which this Agreement is in force shall be calculated at the rate of 2% (two percent) of the Gross Premium Income of the Company for such year.

2. In respect of each year during which this Agreement is in force, the Company shall pay to the Reinsurer, a deposit premium of C$20,000 (twenty thousand Canadian Dollars) in four equal quarterly instalments as follows:

1st January	C$5,000
1st April	C$5,000
1st July	C$5,000
1st October	C$5,000

3. As soon as practicable after the 31st December of each year during which this Agreement is in force, the Company shall send to the Reinsurer a statement of the Gross Premium Income for such year, and the balance of premium calculated in accordance with paragraph 1 above, after taking into account the deposit premium paid in accordance with paragraph 2 above, shall become payable by the Company to the Reinsurer or refunded by the Reinsurer to the Company as the case may require.

4. The term "Gross Premium Income" as used herein, shall mean the gross original premiums resulting from all insurances and reinsurances described in Article 1, encashed by the Company in respect of such year, after deduction of cancellations and return premiums and gross original premiums paid or payable by the Company for reinsurances which inure to the benefit of the Reinsurer.

This is a very simple Article. but at the same time it is of immense importance and is likely to give rise to serious misunderstanding and disagreement, unless it is carefully studied by the principals and the true intention clearly established.

It may well be that at the time of the negotiations between the parties, the reinsurance premium was stated very broadly to be "X% of GPI". When drafting the contract wording it is essential to decide exactly what this is understood to mean.

In paragraph 4 it is seen that there are two basic elements:

(a) the description of the premium income

(b) the source from which it is derived.

In the Article quoted above, (a) is described as "gross original premiums". Unfortunately this apparently clear description may not mean the same thing to different companies or in different countries. For example, does the premium collected from the Insured include taxes, fire brigade charges, stamp or policy charge or special surcharges ? If so, are these extraneous amounts part of the gross premium or not ? Similarly, is agency commission to be included, bearing in mind that some institutions account only for strictly nett premiums and others do not pay agency commissions or brokerages.

It seems that much difficulty would be eliminated if "GPI" were linked to figures used in compiling the Company's annual balance sheet

and described as such, for it is probable that it was the equivalent of these figures from previous years which were submitted to the Reinsurer when the Company was asking for quotations, and which will be used quite automatically by the Company for the calculation of the re-insurance premium.

As was seen when considering Article 6 (Period of Reinsurance), the contract applies to occurrences happening during the period, which is equivalent to the cession and withdrawal of the portfolio of un-expired risks at the commencement and termination of the contract
 period. In view of this there is a strong case for the use, not of gross premium income but of gross earned premium income as the basic premium on which the reinsurance premium is to be calculated.

A method frequently used to arrive at the earned premium is to take the sum of 50% of the previous year's gross premium income and 50% of the current year's gross premium income, but some companies have their own formula and method, and indeed in some countries the Insurance Legislation provides a formula to determine the earned premium.

In fact, the use of gross premium income as the basic premium may produce a very distorted result. It is probable that if the Company has a sharply rising income. the Reinsurer is likely to receive a premium in one year much larger than expected or intended, whereas on a reducing premium income the contrary might be true. Indeed, if it were a "running off account" and no special provision had been made, the Reinsurer might not receive any premium at all!

From this it will be seen that there is a qualification of gross premium income or gross earned premium income which must be considered during the negotiations, namely the method of accounting for the original premiums. In paragraph 4 above this is described as "— premiums — encashed by the Company —". This is not ideal, although it is probably quite fair to both parties, but there are numerous other descriptions used from time to time, such as "accounted for" or "written premium" or "becoming due", which may be more appropriate in some cases. Each has its merits but similarly each can be a source of misunderstanding unless the principals have agreed upon the exact intentions.

Turning now to (b) above, the source of the premium income must be accurately described, because the intention is that the reinsurance

rate is to be applied to all categories coming within the scope of the reinsurance. When the principals are negotiating the reinsurance and again when drafting Article 1, the exact scope of the reinsurance receives careful attention, and it would seem therefore that one cannot do better than to link the source of the original premiums to the description given in Article 1. There can then be no misunderstanding at the outset, and if any alteration is made to Article 1 in future times, such alteration is carried forthwith into the implementation of the present Article.

This will seem very elementary to those experienced in the drafting of excess of loss reinsurance contracts, but nevertheless it is worthy of repetition, when it is realised that a text recommended as standard by one section of the market, reads: "The term premium income shall mean gross premium income of the Company on business protected hereunder during the period of this Agreement, less etc —".

The reader may well ask himself what is meant by "business protected hereunder". In every class of insurance there is almost certain to be a great number of policies which are not, in fact, protected in any way by the excess of loss reinsurance, because of the small sum insured on each in relation to the deductible, and the restricted nature of the perils insured against. Is it the intention of the Reinsurer that the premium from such policies should not be included in the basic premium income ? This seems very unlikely.

Similarly, what is meant by "protected hereunder during the period of this Agreement" ? Does it mean that the gross premium income is to include only a pro rata share of the annual premium for policies which are protected for less than one year ? This also seems doubtful as it is in conflict with the expression "gross premium". Does it then mean that the gross premium income is to include the full annual premium for every policy protected for however short a time ? If so, many policies would contribute two annual premiums, one for the protection from 1st January to the renewal date of the policy and another for the protection from such renewal date to 31st December. It is difficult to believe that this is the intention of the Company.

The practice of paying a deposit premium, as set out in paragraph 2 above, is an interesting feature of excess of loss reinsurance. It seems to have been introduced at an early stage of the development of this method of reinsurance. The original reasoning is now obscured by

time, but it seems probable that it was a natural development. When considering the rating of a contract, it was but a step to estimating the reinsurance premium which would be earned in a full year, and no doubt it seemed quite reasonable to make periodic payments in advance, bearing in mind that claims when they arise are likely to be important and that the Company will receive claim reimbursements immediately that payments have been made. Also most Companies probably prefer the simple method applying under a majority of contracts, of periodic payments plus one annual adjustment, rather than
290 the complicated accounting procedures used for most proportional reinsurances.

Whatever may have been the original thought, the practice of paying deposit premiums is now well established. On fixed rate contracts the deposit premium is usually 75% of the expected full annual reinsurance premium, sometimes payable in full at inception, but more usually payable in half-yearly or quarterly instalments in advance, according to the amount of money involved.

The deposit premium is often also a minimum premium imposed by the Reinsurer. One can fully understand that for a reinsurance applying to a class of insurance which is a new development for a Company, or one where the future premium is doubtful, the Reinsurer may feel that he is entitled to a minimum for the service which he provides.

However, when arranging reinsurance for an established class of insurance, it is difficult to understand why the deposit premium should so frequently be described as a minimum also. The minimum and deposit premium is calculated on known factors, namely, the premium income for previous years and expected annual growth. If the Company sustains a substantial reduction in its premium income, there will be some reason which can be easily identified, such as a reduction of business or withdrawal from a class of insurance, because of deteriorating claims experience or because rates have been reduced to an unacceptable level by competition from other insurers, or because of nationalisation in a territory from which a greater or smaller part of the income is derived. In the event, the Reinsurer will recognise the facts and it is difficult to believe that the Reinsurer would endeavour to exact the minimum premium if it were not earned.

Article 10. Reinstatement

At the end of the comments on Article 3, (Deductible and Limit of Liability) reference was made to reinstatement. There are a number of variations of this Article, but the following is an example suitable for this review:

1. Should a loss arise hereunder the limit of liability of the Reinsurer is reduced by the amount of such loss as finally determined, from the date of commencement of the loss. Nevertheless the amount by which the limit of liability is so reduced is automatically reinstated (subject to paragraph 3 below) and an additional premium becomes payable by the Company calculated at pro rata of the premium for the year as stated in Article 9, from the date of loss to the 31st December next following the date of loss, in the proportion that the amount reinstated bears to the limit of liability of C$100,000 each and every occurrence, stated in Article 3(2).

2. Should there be more than one loss each shall be dealt with in accordance with paragraph 1 above.

3. The liability of the Reinsurer shall not be more than the amount stated in Article 3(2) namely C$100,000 in respect of any one occurrence or more than 200% (two hundred percent) of such amount in respect of all losses arising during any annual period for which this Agreement remains in force.

The word "reinstatement" is certainly not ideal to express the intention set out above. Originally the term was probably borrowed from the theory and practice of Fire Insurance. In that context the theory was clear. The subject matter was insured for its full value; if a total loss occurred the policy had been fully used up and the contract was determined. If a partial loss occurred, part only of the policy had been used and the remainder continued to protect the remaining part of the subject matter. When the property destroyed was replaced a corresponding amount of new insurance was required, so the full amount of the policy was reinstated and a premium paid.

It is merely a matter of convenience that this increase in the sum insured is dealt with under the existing policy. It can be, and no doubt frequently is, the subject matter of a new policy.

Be that as it may, "reinstatement" in an excess of loss reinsurance is generally recognised as a method of imposing an aggregate limit

under the reinsurance and obtaining an additional premium when a loss occurs.

For the purposes of the following remarks and to avoid unnecessary complications, it is assumed that the contract is for 12 months from and including 1st January, that it is at a fixed rate of premium calculated on gross premium income which it is assumed will produce C$2,000 when finally determined, and that the deductible and limit of liability each and every occurrence are as stated in Article 3 above.

The following is a recapitulation of the effects of the reinstatement condition quoted above:

(a) The Company cannot recover more than C$200,000 in the aggregate in any one year of reinsurance.

(b) The number of losses is not limited. For example, in an extreme case the Company could recover 200 losses of C$1,000 each.

(c) If the Company has no losses the premium payable is as stated in Article 9.

(d) If the Company has a loss or losses, the premium will be increased in the function of the two factors:

(i) The amount of each loss

(ii) The date of each loss.

Attention is drawn to the fact that the date of loss is the date upon which the loss commences. This can have its importance, particularly in the extreme case where a loss may continue for a period of days.

As an example of the calculation of an additional premium, suppose that a loss commences on 1st April, and that the amount eventually paid by the Reinsurer is C$50,000. The formula is as follows:

$$\frac{\text{amount of loss}}{\text{limit of liability each and every occurrence}} \times \text{annual premium} \times \frac{\text{unexpired period}}{\text{annual period}}$$

Which is in the above case:

$$\frac{50{,}000}{100{,}000} \times 2000 \times \frac{275}{365} = 750 \text{ (approximately)}$$

A number of points arise from the application of the reinstatement condition:

(A) The Company is *required* to reinstate cover as and when loss or losses occur, to the extent of the reinstatement limit.

(B) The additional premium payable is in proportion to the amount reinstated. Some clauses, widely used, and indeed imposed in

certain markets, imply that the relative additional premium should be in proportion to the amount of the loss. One such clause reads: "... an additional premium, calculated at pro rata of the premium hereunder, for the period from the date of such reinstatement to the expiry of this Agreement, shall be paid by the Company upon the amount of such loss ...". It seems very improbable that this is the intention and the misconception may arise because the two figures, i.e., the loss and the reinstatement are frequently the same, but this is not always so.

Suppose that the limit of liability each and every occurrence is 100,000 and the aggregate limit is twice that amount, namely 200,000. On 1st February a loss occurs for which the Reinsurer's share is 100,000. That amount is reinstated and the relative additional premium paid, so that the Company still has cover for 100,000.

On 1st June a further loss occurs for which the Reinsurer's share is 70,000. There is no reinstatement and no additional premium is payable, because full reinstatement has already been dealt with. The Company has 30,000 available to meet subsequent claims.

However, if the loss on 1st February had been for 70,000, the amount would be reinstated and an additional premium paid. If the next loss on 1st June were for 50,000, only 30,000 would be reinstated and the appropriate additional premium paid, so that there would have been reinstatement for the full 100,000. In this instance, the Company would have available 80,000 to meet any subsequent claim.

(C) It may seem illogical that the additional premium is calculated from the date of reinstatement, for this means that if a loss for 100,000 occurs on 2nd January, the additional premium will be almost an entire year's premium, whereas if it occurs on 30th December practically no additional premium will be paid, although in both cases the Reinsurer's share of the loss is the same.

To meet this objection, some Reinsurers have developed a formula whereby the additional premium is calculated as if the loss or losses had occurred on the 1st July, irrespective of the true date of the loss or losses.

(D) Although the aggregate limit is frequently expressed as "one full reinstatement", i.e., twice the limit of liability each and every occurrence, any other number of reinstatements can be agreed upon by the parties if they so wish.

Naturally, any large increase in the aggregate limit would be reflected in the rate of premium, and if a Company decided that it

should, for its complete protection, have a substantial limit, it might be found more advantageous to take out a separate reinsurance which would apply only when the aggregate limit under the standard excess of loss reinsurance had been entirely used.

(E) There is considerable variation in practice in respect of the application of the reinstatement condition. The most usual is for the condition to apply to all the classes of insurance to which the reinsurance applies.

On the other hand it may apply only to the Extraneous Perils —
294 such as Earthquake, Riots, Strikes, etc., and Windstorm. There are sub-divisions of this general basis, for example, an aggregate limit for all such perils together or separately.

In each instance, if additional premium is payable, very careful thought must be given to the method of calculation of such additional premium. Is it to be calculated on the gross premium income for all the classes of insurance covered under the reinsurance, or on the gross premium income for the Extraneous Perils only, or some other basis. Sometimes to avoid unnecessary complications and the accounting costs of providing a division of the gross premium income into the various perils involved, a fixed figure is estimated during the premium negotiations, on which the pro rata additional premium, can be calculated, as if the estimated figure were the true annual premium for the perils in question.

Article 11. Inspection of books

The following is a standard clause which is widely in use:

Particulars of the policies to which this Agreement applies shall not be required by the Reinsurer but the books of the Company as far as they concern such policies shall be open to the inspection of an authorised representative of the Reinsurer at any reasonable time during the continuance of this Agreement or of any liability thereunder.

Little comment is necessary. Except in contracts applying to specialist classes of business, it is not now customary to require the Company to provide the Reinsurer with detailed information relative to the risks written, although the Reinsurer usually has the right to inspect the books of the Company.

Such right is rarely exercised unless difficulty arises between the parties. This is perhaps regrettable because it might be of great value

to both parties if the Reinsurer were to make an occasional examination of the books and records, so as to familiarise himself with the operations of the Company.

At the time of a meeting for this purpose the principals could discuss many facets of the business, to the instruction and advantage of both, and the misunderstandings, which do arise from time to time as to the classes of insurance included or excluded from a particular contract, would be eliminated.

In some instances, there is a tendency for the Company to feel that if the Reinsurer implements the agreement set out in this Article, that there is doubt as to the Company's integrity. However, the Company through its agents, almost certainly makes regular and quite frequent visits to its Insureds, without the latter being in any way affronted.

Article 12. Errors and omissions

The following is the usual text used in respect of this Article:

No accidental error or omission on the part of the Company shall relieve the Reinsurer of liability under this Agreement provided that any such error or omission is rectified as soon as possible after discovery.

The Article still continues to appear in most excess of loss reinsurance contracts, although it is doubtful whether it gives the Company any additional protection.

The utmost good faith is inherent in the contract and it is very difficult to imagine that a Reinsurer would seek to take advantage of the Company's error to avoid any liability which would otherwise attach to the Reinsurer.

Article 13. Arbitration

There are many different texts in use for this Article, but the following is one which is usually quite acceptable to both parties:

1. In the event of differences arising between the contracting parties with reference to any transactions under this Agreement, such differences shall be submitted to arbitration upon the request of one of the contracting parties. The Company and the Reinsurer shall each nominate an arbitrator and the two named shall elect an umpire before entering upon the arbitration. The arbitrators

and umpire shall be Managers or Assistant Managers of Insurance or Reinsurance Companies.

2. In default of either party nominating its arbitrator within 30 (thirty) days of the other party requesting it to do so, the Superintendent of Insurance shall, upon request, appoint the arbitrator for the defaulting party.

3. If the arbitrators do not agree upon an umpire within 30 (thirty) days of their appointment, the Superintendent of Insurance shall, upon request, appoint the umpire.

4. Within 30 (thirty) days of the appointment of the umpire, the party requesting arbitration shall submit its case in writing to the arbitrators. The latter shall immediately transmit this to the other party who shall be allowed 30 (thirty) days in which to reply. The arbitrators shall consider the differences between the parties and shall submit to the umpire only those questions upon which they disagree. The arbitrators and the umpire may, if they so decide, call either or both parties to be heard.

5. An award in writing shall be made by any two of the three (two arbitrators and one umpire) within 120 days of the umpire having been appointed and such award when filed with the Company and the Reinsurer shall be binding upon both parties. The arbitrators and the umpire are relieved from all judicial formalities and may abstain from following the strict rule of law, interpreting the present Agreement as an honourable engagement and not as a merely legal obligation.

6. Any arbitration shall take place in the town in which the Head Office of the Company is located, unless otherwise agreed. The cost of the arbitration shall be borne as the Court of Arbitration decides.

When the wording of a reinsurance contract is being considered, the arbitration clause does not always receive the degree of attention which it should.

Many a man has spent his entire working life in the insurance and/or reinsurance industry without ever being involved, even remotely, in an arbitration. It is perhaps for this very reason that principals should be quite certain that the arbitration clause in any contract which they sign will perform as they expect, should the necessity for arbitration arise.

It is self evident, but should nevertheless be emphasised, that it is only when there is no possibility of a compromise that the parties resort to arbitration.

The insurance industry is reproached from time to time that it prefers to settle its reinsurance disagreements by arbitration rather than to submit such disagreements to the commercial courts for decision. The inference inherent in such a reproach is that an award by arbitration does not necessarily reflect the true legal position.

This view, which when expressed is usually expressed by lawyers, of whatever degree, may overlook the essentially practical side to the matter, which is extremely important to the Company and the Reinsurer involved.

Firstly the parties wish to have a simple common sense answer to what is possibly a very complex question; they wish the answer to be given by men who understand the industry and who will try to understand the basic intentions of the parties at the inception of the contract; they require the answer to be given quickly and without any avoidable expenditure of money.

To those who have not been involved in an arbitration, it may appear that it is a simple process, and that all that is necessary is to submit a simple statement to sympathetic friends, explaining that the other party is being completely unreasonable.

It is not at all like that. First of all it may not be easy to find men of experience who are willing to act as arbitrators. A man of managerial standing in the industry will certainly have a year-long programme of activity, which it is very difficult, if not impossible, to disrupt for the purpose of settling the difference of opinion between the parties involved, with both of whom he is probably on friendly terms and possibly in business relationship. Indeed, the greater the integrity of the man, the more searchingly will he ask himself whether he is judging the case coldly and independently and to what extent his judgment is influenced by considerations extraneous to the questions submitted for decision. Also, such a man may fear that if he accepts the nomination, he may find that as the case proceeds he is totally opposed to the views put forward by the party which has nominated him. Is he then to act as advocate or juryman ?

So, the very first step in the arbitration, the appointment of the arbitrators is fraught with difficulty and it is essential to make provi-

sions for some independent authority to have the power to appoint suitable men, should the parties not be able to agree even upon such fundamentals. The Superintendent of Insurance is mentioned in the Article quoted above, but very frequently the independent person is the President (for the time being) of one of the Insurance professional bodies.

After the appointments comes the really difficult part, namely the formulation of the case by the party requesting arbitration. The complaint may well be that "the X will not pay my claim", but the

arbitrators may expect something more detailed, and unless some volume of correspondence has passed between the parties, it may be very difficult to anticipate and refute the reasons and arguments likely to be submitted by the other party. Thus, calling the parties to be heard may prove to be extremely important.

It is essential to state in the arbitration clause where the seat of arbitration will be. It is usually in the country of the Company. This will probably decide the language or languages in which the proceedings will be conducted, which will in turn have a bearing on the nomination of the arbitrators and the umpire. It is likely also to have an important influence on the attitude of the arbitrators towards points of law or practice which may not be the same in the country of the Company and that of the Reinsurer.

Arbitration has proved to be of value in many cases of disagreement and it is regrettable that the parties are reluctant to make available to the industry as a whole, the findings of the arbitrators in particular cases. It is because of this lack of information that there is the possibility that principals are operating under contracts which contain the seeds of disagreement, without the parties being aware of this until the difficulty becomes apparent in practice, notwithstanding that the same difficulty has already been resolved in another similar case.

Truly, the decision of arbitrators in one case is not binding on the parties to another contract, but at present either or both the parties may be ignorant of the possibility of the particular conflict of interest, until it manifests itself, possibly in difficult circumstances.

If there were a central register of cases submitted to arbitration stating the findings of the arbitrators, the parties to similar contracts would be alerted and could negotiate by agreement the method to be adopted should they be confronted by such a difficulty at a later date.