

The Special Termination Clause

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Reinsurance Dialogue

between

Christopher J. Robey*

and

David E. Wilmot

December 7, 1994

Re: The special termination clause

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Dear Mr. Wilmot,

Effective date of termination

It is clear that this clause has had little attention paid to it in the last thirty years. It reads much like it did when I first read a reinsurance contract, with the only major changes being those you discuss in your letter. It would therefore seem to be time to have a closer look at it, so rather than introduce a new subject this time, I shall take the first part of this letter to discuss the points you raise and the second suggesting some ways in which the clause can be changed to reflect better the world in which it is now used.

As you write, the only real change in the clause has been to change the date when termination takes effect. Certainly, in the case of the pending insolvency of the ceding company, reinsurers should provide protection until all policies in force have been canceled. One month, as you have proposed, should be enough.

Insolvency of the reinsurer gives rise to different considerations, however, and, again as you point out, has

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resulted in the introduction of revisions strongly favouring the ceding company. I think the principle of protecting the ceding company in such circumstances is the right one, since the public policy purpose of the insurance and reinsurance business is to provide protection to the general public.

There are a number of considerations for the ceding company in fixing the termination date other than at the date for normal termination. If the reinsurer is insolvent, there is certainly a worry about incurred but not reported claims, but this is no greater than for those already reported but on which nothing has been paid. If the intention is to obtain a replacement reinsurance, it could be difficult to have the new reinsurer pick up such claims anyway.

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Rather, I think the major consideration is one of administration of the contract.

Proportional contracts provide for quarterly accounts and usually cover losses which either occur during the contract year or are covered by policies which incepted or renewed during the contract year. Termination at other than the end of a quarter would require the ceding company to produce a broken quarter account for the terminated reinsurer and the replacing one. More complicated would be the need to track losses or policies issued around a date which is not one of the "natural" dates for such things. Certainly computers can do it with ease, but they have to be programmed to do it first and experience with insurance company computer programming will quickly show that it is often not feasible.

Even tracking losses or policies issued around a quarter presents much greater complications than does doing so around the contract period, for which it will be done anyway for all other reinsurers. Commission adjustments will be affected the same way.

For excess of loss contracts the tracking of losses is easier, since they are handled individually anyway. Here the difficulty is with contracts subject to an adjustable rate or a

minimum premium. Of course, the rate can be adjusted for the period the contract was in force, and the minimum premium prorated for that period, but most contracts are rated on the basis of an annual term and the price for a short term contract would normally be significantly higher, so the terminated reinsurer does not necessarily get the premium it should and the ceding company must pay a surcharged premium to the replacing reinsurer.

All changes raise questions under the unwritten "most favoured reinsurer clause", although other participating reinsurers would be unreasonable not to allow different terms in such circumstances.

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It is evident that the case for retroactive termination, whether to the beginning of the quarter or the anniversary date is weaker on excess of loss contracts, but it offers a practical solution to the ceding company nonetheless.

From the point of view of the reinsurer, or rather the liquidator, it also has advantages. The main task of the liquidator is to maximize assets and minimize liabilities, while completing the liquidation in as short a time as possible. Elimination of all in-force contracts would certainly meet that requirement. Not only would there be a significant reduction in workload, but the liabilities incurred under them would be wiped out, while any premium would be returned only as a dividend in the liquidation, except for what can be set off against losses and commission already paid by the reinsurer.

There is of course the potential for abuse of a retroactive cancellation condition, but faced with choosing between an insurer continuing to provide protection to the public and an insolvent reinsurer, I will choose to give every advantage to the insurer. Nonetheless, I agree that it is not right to apply it to most of the reasons for special termination, and I would restrict its application to circumstances which suggest the reinsurer is in financial difficulty.

Changes to the clause

You are quite right in saying that the clause needs revision to differentiate between the triggers for termination and the remedies provided and I should like to make some suggestions as to what could be done. This is not an attempt to redraft the clause itself, but rather to suggest some guidelines which can form the basis of such a redrafting. Since the Reinsurance Research Council has not produced a recommended wording, I shall use as a starting point the triggers in the “Reinsurance” course book of The Insurance Institute of Canada (IIC) and compare the approaches used in the following additional references:

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Reference Work	Author, editor or publisher	Abbreviation in this text
Model Treaty Wordings	Canadian Reinsurance Company	Canadian Re
Contract Wording Reference Book	Brokers and Reinsurance Markets Association ¹	BRMA
Reinsurance Contract Wording	Robert W. Strain	Strain
The Law and Practice of Reinsurance	C. E. Golding	Golding
Reinsurance	R. L. Carter	Carter

I shall put each trigger into the “voluntary” and “involuntary” categories you propose, but also into two categories which I think are more appropriate — category 1 for triggers requiring urgent action by the other party and category 2 for those which warrant examination by the other party but not necessarily action. And, since the impact is different depending on whether the trigger happens to the ceding company or the reinsurer, I shall look at the consequences from both points of view.

¹An American market association.

Loses the whole or part of its paid-up capital

This is certainly in the involuntary category and, as you suggest, it is the first candidate for change. Just under the letter C in the 1994 T.R.A.C. Report there are eight companies with impaired capital and four others with negative earned surplus but enough contributed surplus to avoid having this impair their capital. I recall a few years ago a company converted its contributed surplus to capital and ended up with impaired capital as a result.

The weakness is the reference to paid-up capital, since it is only part of the company's own funds and has no application at all to mutual companies. A better reference would be to the statutory surplus at inception of the contract, with the trigger being a percentage reduction in this amount during the term of the contract. This is the approach taken by Strain and BRMA, with the trigger at 50%.

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You suggest referring to failure to meet the minimum asset requirement instead of a reduction in paid-up capital and this is similar to the approach taken by Carter, which refers to a petition for winding-up being presented or a resolution for voluntary liquidation, but has no trigger for a reduction in surplus. There is a similar trigger in the IIC course and I think that one, along with the trigger dealing with a company ceasing to write business, provide enough protection to do away altogether with a trigger tied to a reduction in surplus.

Goes into liquidation or has a receiver appointed

All the references have variations on this trigger, which is the most important of all, falling into your "involuntary" category and my category 1.

This trigger clearly pre-dates to-day's practice of the regulator taking over a company in financial difficulty before the liquidation process is begun. Although I think this trigger no longer has much practical value, it would probably be difficult to take it out. However I would combine it with the trigger dealing

with the order by a regulator to stop doing new or renewal business.

Ceases to underwrite new or renewal business following a decree of an Insurance department or other competent authority

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Carter does not refer to ceasing underwriting at all and Strain refers only to "ceases writing new or renewal business", which could be voluntary or involuntary, and I think voluntary and involuntary triggers should be kept separate. The other references all have variations on this trigger.

This has probably become the key trigger to-day, given the powers of the regulator. However, greater precision is necessary to reflect the international operations of many companies, particularly reinsurers. I recall a few years ago when Lloyd's was ordered to stop writing new and renewal business by a small American state over a commercial dispute. It was quickly settled, but nonetheless this action gave any ceding company or reinsurer of Lloyd's anywhere in the world the right to invoke immediate cancellation under this trigger.

I suggest the reference to "an insurance department or other competent authority" be limited to the regulator in any jurisdiction where the ceding company issues the policies which are the subject of the contract and the regulator in the offending party's home jurisdiction. This will be sure to pick up financial problems and would also pick up operating irregularities on policies which are reinsured, but eliminate disputes in irrelevant jurisdictions. Where the party is a branch outside the jurisdiction of the head office regulator, the regulator of the branch should also be included.

As to what to do, it would depend on the circumstances. If the offending party is the ceding company, a minimum of thirty days notice is essential to ensure the orderly transfer of the original business to other carriers. If it is a reinsurer, I favour the ceding company having the right to fix the termination date at the time of its choice in the contract year.

including retroactive to the anniversary date. At a minimum, it should be able to choose any date within the quarter in which notice is given.

Of course, local laws may make any provisions in the contract redundant, since the regulator is first and foremost interested in protecting the general public and may well have in place a procedure which overrides the contract. Even if no such procedure is in place, in the case of problems with the ceding company, the regulator can exert considerable pressure on reinsurers licensed in its jurisdiction.

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Merges or passes under another financial control

This trigger is clearly voluntary and falls in my category 2, since it would be rare that the new people in control would be viewed by the other party with such opprobrium that immediate termination would be invoked. However, if that were the decision, I would make the termination in either direction a minimum of thirty days by the terminating party, with the terminated party having the option to choose an earlier date, but not earlier than the date of the change.

Where this trigger needs work is in the definition of “financial control”.

In fact, only Golding and BRMA have such a short clause. Strain suggests “has any change of ownership, considered to be 10% or more of its stock and/or a change in senior management”, but applies it to the ceding company only, with no corresponding trigger applicable to the reinsurer. This wording also refers only to change of immediate ownership of the party and would not apply to a change in the owner of the owner of the party — a holding company, for example. On the other hand, applying a 10% ownership change to a chain of owners would be impractical. Also, a change in senior management could be just one person, and not necessarily the person involved in the business reinsured — the Vice President, Human Resources, for example. Acting on such a change is unlikely, of course, but you

have yourself raised the possibility of one party using such a change to take advantage of the other.

678 Carter does not specify what a change in control is, saying “if the business of either party be acquired controlled or administered by any other company corporation or authority *de facto*, or if there is a material change in management”. The problem I see here is that such expressions as “*de facto*” and “material” are subject to interpretation and therefore not what one wants to see in a clause providing for immediate action. Nonetheless, some subjectivity seems inevitable, given the length of any clause which sought to define all contingencies, not to mention the inevitability of missing some.

All in all, I like the Canadian Re version best — “enter into any arrangement by way of shareholding or management or otherwise under which effective legal or presumptive control is assumed by any other individual or organization than that which pertained at the time this Agreement became effective”. I think we can do better than “pertained”, but that is a small point.

Agrees to any arrangement which would end its separate existence

If there is no change in control, I do not see the need for termination for this reason and I would eliminate this trigger. It does not appear in any of the other references.

Reinsures 100% of its total portfolio without previous written consent of the other party

Although I can understand why the reinsurer would want this provision in the contract, I think it could be dealt with better by a retention warranty outside the sudden death clause. After all, why would there be concern at 100% reinsurance but not at 99%?

As for the ceding company, the concern would be that decisions were no longer being taken by the individuals with

whom the contract was negotiated, which is similar in many ways to the change of control trigger and I think a well-designed change in control clause would be better.

Golding and Carter do not have this trigger. Strain and Canadian Re refer to “a reduction in the net retained share of the business hereunder”, which a retention warranty would deal with. In Strain, the trigger is limited to a reduction by the ceding company, but no such limitation appears in the Canadian Re version, which could therefore be interpreted as preventing a retrocession of the business reinsured, which is certainly not the intention. BRMA refers to the 100% reinsurance of the business reinsured.

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The situation is different if the assignment of the contract is involved, and that is perhaps what this trigger was original designed to deal with. However under an assignment another company is substituted for the original one, rather than assuming the risk through reinsurance. Many jurisdictions, including in Canada, allow for transfer of business from one company to another with a type of “negative option” approach to the consent of other contracting parties.

A special termination trigger for assignment can certainly be justified, but I would prefer to see an automatic termination provision, which would then force the party contemplating the assignment to seek the agreement of its contracting parties in advance. I suspect that such a provision could not override local laws, but it would at least cause the assigning party to consider that it may be better to be safe than sorry.

Other triggers

There are other possible triggers, such as war between the countries of domicile of the two parties or a change in law which makes the contract illegal, but these would seem to result in automatic termination without need for a provision in the contract.

Notice of the happening of a trigger

Only Canadian Re requires the party to which the trigger happens to advise the other, a provision which I think should be mandatory. Indeed, where the change is voluntary, a case can be made for prior notice.

After expiry

680 All the clauses provide for termination of the contract, but none deal with what should be done if the trigger occurs after expiry but while there are still liabilities outstanding. A provision for withdrawal of unearned premium, if any, and outstanding losses would seem desirable, perhaps at pre-determined terms which offer something of a penalty to the party requiring the withdrawal. This would discourage arbitrary action, but leave open the possibility should circumstances warrant it.

Yours sincerely,

A handwritten signature in cursive script, reading "Christopher J. Robey". The signature is written in black ink and is positioned above a horizontal line that extends across the width of the signature.

Christopher J. Robey