Assurances

From Most Favoured Reinsurer to Contract Intent

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Volume 58, numéro 4, 1991

URI : https://id.erudit.org/iderudit/1104812ar
DOI : https://doi.org/10.7202/1104812ar

Aller au sommaire du numéro

Éditeur(s)

HEC Montréal

ISSN

0004-6027 (imprimé)
2817-3465 (numérique)

Découvrir la revue

Citer ce document

Wilmot, D. (1991). From Most Favoured Reinsurer to Contract Intent. *Assurances*, *58*(4), 601–607. https://doi.org/10.7202/1104812ar

Reinsurance Dialogue

between

Christopher J. Robey[1]

and

David E. Wilmot[2]

December 4, 1990

Re: FROM MOST FAVOURED REINSURER TO CONTRACT INTENT

Dear Mr. Robey,

Like you, I have tended to assume, without ever actually seeing, the existence of the "Most Favoured Reinsurer" clause in reinsurance contracts. It is accepted market practice that terms and conditions will be concurrent for all reinsurers on a given treaty. However, I am not prepared to concede that the principle of most favoured reinsurer is consistently embraced by all parties to a reinsurance agreement.

Certainly, there is expected to be a degree of uniformity of terms and conditions within reinsurance contracts "shared" by many reinsurers. However, this uniformity may be nothing more than the simple expedient of keeping reinsurance programmes from becoming administratively uncontrollable. Indeed, cedants, reinsurers and brokers are all busy people during the treaty renewal season, and they must be able to make certain assumptions without continually asking questions. "Is this treaty based on Utmost Good Faith? Was there full disclosure of relevant information without

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misrepresentation? Are the treaty terms fundamentally the same for all participants?"

For practical reasons, I believe there is a need for concurrency of terms (or at the very least, for disclosure if terms are not concurrent), but I do not necessarily support the most favoured reinsurer concept.

To better explain this, I must first ask you to broaden your definition of "most favoured reinsurer" beyond terms and conditions. There are at least three "levels" at which concurrency may or may not take place in a reinsurance contract. These are: the level of *treaty description,* the level of *terms and conditions,* and the level of *supporting assumptions, intentions, disclosures and related written or verbal exchanges.* I contend that the property and casualty insurance industry frequently ignores or circumvents our "most favoured reinsurer" clause at each of these levels.

At the level of ***treaty description,*** you have already given the example of separate treaties, or, at least, separate treaty descriptions, to reinsure a common layer of cover. When a non-proportional treaty of $500,000 excess of $500,000 could not be completed at one set of terms and conditions, a (similar) layer was sold at what may or may not have been a higher price. A more widespread example of non-concurrent treaties which serve an identical function can be found during a capacity crisis such as that of 1985. Toward the end of that year, "wrap-up" treaties were marketed and sold to fill gaps in casualty excess and property catastrophe excess programmes. At that time, many insurers found they had unplaced shares in one or more of their excess layers in addition to their net retentions. Reinsurers offered special covers to wrap these liabilities together into a single net retention which would then be protected by a separate excess treaty. Almost without exception, these "wrap-up" treaties were priced above the original (incomplete) covers. As a result, the wrap-up reinsurers enjoyed a better ratio of premiums to risk exposure than those reinsurers who signed shares of the original programme.

One may argue that, when treaty *descriptions* are different, concurrency of *terms* (concurrency of price) cannot be compared, and therefore, the alternate treaty is not in contravention of the most favoured reinsurer concept. I would argue that the new treaty, and *particularly* its description, suggest that the most favoured reinsurer concept has been circumvented. Clearly, the ceding company found a different means of achieving the same end, and separate reinsurers or groups of reinsurers, offering coverage on more or less the same level of risk, experienced different terms, conditions and results.

Mind you, I don't have a problem with this. I'm not even sure there is an obligation to inform the first set of reinsurers that an alternate solution was found to complete the programme. However, I am concerned with the question of who, if anyone, may be harmed. The original reinsurers got their price and cannot complain. The wrap-up reinsurers got what they required and are most unlikely to complain. The cedant completed its cover, and probably did not pay more that the "correct" price. But, in the long run, it is most likely the ceding company who has been harmed. It is the cedant who has told its reinsurers "it pays to delay putting forward authorisations" in a hard market. It is the cedant who has spent a portion of its reinsurance premium on "once-only" reinsurance with no bank.

The second level of concurrence is in the realm of ***terms and conditions.*** It is on this basis that many reinsurers define the concept of most favoured reinsurer. But again, I am not sure the principle is widely supported. There have been pro rata treaties with lower commission terms for a favoured (or stubborn) reinsurer and there have been excess treaties with higher rates for a more demanding reinsurer. Even where terms *are* concurrent, one reinsurer will often receive more favourable "overall terms" than another. A reinsurer who fills the last 10% of a hard-to-complete excess treaty may demand and get a 20% share of another, more attractive treaty. A reinsurance broker may insist that all reinsurers take an "across-the-board" share of a multi-layered programme only to sign one reinsurer down on the better priced layers while allowing another more favoured reinsurer to opt out of the thinly rated layers.

It would be naive to assume each reinsurer will receive equal treatment. However, because market practice suggests concurrency of terms and conditions, at least within each treaty, it may be obligatory to disclose any deviations from this practice. And, when a broker ties a treaty programme together, demanding equal shares on all layers, then that too has become a single contract demanding concurrency among reinsurers.

The third level of concurrence must be that of ***intent.*** One cannot safely assume that all reinsurers, let alone all parties, share the same understanding of intent within a single treaty or treaty programme. Usually, cedants and reinsurers are safe in the knowledge that *market practice* will establish treaty intent where the contract itself is silent or unclear. However, neither the wording nor market practice can be expected to capture every intention of every party to the reinsurance agreement. Here is a potential problem: all parties cannot be subject to each others' interpretation of the contract. All reinsurers cannot be aware of the stated undertakings of each of the other reinsurers. The treaty cannot be concurrent on each point or nuance of intent as expressed by individual reinsurers to the cedant or by the cedant to one or two individual reinsurers.

To explore these statements, I would like to play with an actual situation.

Some years ago, a large hotel experienced a serious fire which took the lives of many guests. The hotel did not have adequate liability insurance, and consequently faced substantial losses that would have to be paid over the following year or years. Yet, the hotel could not put up reserves for these future losses. (Only insurers can carry such reserves.) Insurers offered retroactive liability insurance to the hotel in return for substantial premiums. The premiums were calculated to generate significant investment income over the seven or eight years that claims were expected to remain open. Both the hotel and the insurers believed they had made a good deal. Excess reinsurers, on the other hand, reacted quite negatively to the possibility of paying a sure loss in return for only a small fraction of the insurance premiums. More than one reinsurer issued a blanket refusal to pay for this or any similar retroactive loss.

I do not know what discussions took place between insurers and reinsurers, but I would like to use the story of the retroactive cover to ask some *what if* questions:

What if, *for commercial reasons, one reinsurer had agreed to pay its portion of the loss?* I believe the other reinsurers would not become liable to pay simply because of the actions of one. I am presuming the decision of one reinsurer outside the contract is a separate agreement, non-binding on the others. I will concede that the decision would likely increase the pressure on the other reinsurers to make a similar gesture.

What if *one reinsurer had interpreted the contract to mean the claim must be paid?* We will assume the cedant believed it was entitled to recovery and that one reinsurer supported that assumption. This is a problem of interpretation that may well go to arbitration. If the decision of the arbitration favours those reinsurers who are unwilling to pay, then certainly the interpretation of the first insurer will not impede the decision. Question: after the decision in favour of these reinsurers, will the first reinsurer invoke the *most favoured* principle and decline to pay? I rather think so.

What if *one reinsurer, prior to the acceptance of the hotel risk, had communicated its intention, in writing, that the treaty would respond to just such a claim?* This is no longer a question of interpretation. There is an agreement of intent between the cedant and the one reinsurer. I would go so far as to suggest that, having received support of that one reinsurer (but then having failed, for whatever reason, to communicate with the other reinsurers), the cedant will presume that all reinsurers are committed by this "side agreement." It is the cedant who will attempt to invoke the intended concurrency of reinsurance agreements.

At this point, we must recognise that concurrency does not exist. The treaty is not joint, but rather, several contracts, each with a separate reinsurer, joined only by a commonality of subject matter. The one reinsurer cannot alter the contracts of the other reinsurers by its separate action. And, just as that reinsurer cannot attach the liability of all the reinsurers by its separate actions, it cannot escape its separate contractual liability to the cedant simply because the other reinsurer did not make a similar contractual agreement.

I must conclude that the most favoured reinsurer clause exists as market practice but not as a fundamental principle. There may or may not be an obligation to disclose significant deviations from the principle, although I suggest it makes good business sense to do so. At the same time, the principle does not work in reverse and commit one reinsurer to the special interpretations and side agreements of others.

Disclosure and Intent

Leaving behind the subject of most favoured reinsurer, I would like to further explore two of the ideas raised above, disclosure and intent.

The reinsurance contract is based on utmost good faith. Therefore, the standards of disclosure are quite high. Facts that are material to the reinsuring parties are expected to be communicated, and failure to disclose certain facts can amount to fraudulent misrepresentation.

If a large loss occurs between the date reinsurance underwriting information is prepared and the date reinsurance quotations are to be submitted, such non-disclosure may be interpreted as misrepresentation. The prepared information, which may even state "as at (such and such) a date," is now known to misrepresent the loss experience of the insurer.

When undisclosed material information creates misconception rather than misrepresentation, courts may still interpret non-disclosure as a fraudulent act due to the more strict interpretation of contracts *uberrimae fidei*.

For example, if treaty underwriting information fails to note that the insurer has just entered a new line of business known to produce very large losses and expected to change the character of the subject business, then failure to disclose will undoubtedly create misconceptions regarding the validity of past loss information.

The cedant must disclose material facts of which it has knowledge. Returning to the first example, the claim must be known to be large enough to affect the reinsurer's judgment. What if the insurer makes a concerted effort not to set up large loss reserves close to treaty renewal season? Then the failure to disclose would fall under the second category by deliberately promoting misconception.

Non-disclosure is not always clear cut. Certainly, cedants are not expected to disclose information that a knowledgeable reinsurer should already have in its possession. A quota share reinsurer once took a cedant to arbitration when it discovered that uninsured motorist contributions were being included in the losses. The cedant had not pointed out this material fact, but it was agreed that the procedure was so widely acknowledged as not to require further disclosure by the cedant.

The potential for grey interpretations can be illustrated by looking at any number of treaty renewal practices. For example, many brokers provide catastrophe reinsurers with "net loss" information. Consider the catastrophe proposal for a cedant who maintained surplus protection year after year until very recently. The net losses clearly misrepresent today's exposure to full losses. Is the reinsurer expected to know? When does the reinsurers' responsibility to ask questions end? Has there been a deliberate attempt to create misconception? Such questions are often the stuff of arbitrations. The solution is communication and increased clarity of meaning and intent throughout the negotiation of reinsurance agreements.

I will end by asking a somewhat more difficult question about disclosure. Is the non-disclosure of *intent* fraudulent? Consider this example, which I have framed as an insurance rather than a reinsurance situation. An insured fears a "secret hazard," — one which he suspects any insurer will exclude if brought to its attention. The insured negotiates policy conditions which are subtly intended to include that unspoken hazard, and when the loss does occur, the insured points to the clauses which (now very clearly) favour him. Note that I am not suggesting the insured knew the loss would occur; merely that he perceived an increased potential for that loss. However the insured disclosed neither his suspicions regarding the hazard nor his motives for specific policy changes. The insured did not disclose intent. Was this fraudulent?

I await your answer in the next issue of *Assurances*.

Yours very truly,

David E. Wilmot