Assurances

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

Eric A. Pearce

Volume 41, numéro 3, 1973

URI : https://id.erudit.org/iderudit/1103790ar
DOI : https://doi.org/10.7202/1103790ar

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Éditeur(s)

HEC Montréal

ISSN

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

Découvrir la revue

Citer ce document

Pearce, E. (1973). Excess of Loss Reinsurance: Review of standard clauses: (Fire and Allied Perils). *Assurances*, *41*(3), 212–223. https://doi.org/10.7202/1103790ar

Résumé de l'article

The standard clauses in use at the present time in some contracts of Excess of Loss Reinsurance are being reviewed here.

My remarks are, in general, based on contracts for Fire and Allied Perils and the subject matter must of necessity be open to criticism. Indeed, I hope that friends in the field of reinsurance, be they ceding Companies, Reinsurers or Brokers, will draw attention to any points which in their view are incorrect, liable to misinterpretation or could be more happily expressed.

A reinsurance comes into being as the result of negotiations between the parties. The negotiations may be brief or, on the contrary, very long drawn out, but always without exception the negotiations are treated with the utmost seriousness in an endeavour to equate the requirements of the Company with the protection which the Reinsurer is able and willing to offer.

When agreement has been reached, it is customary (in some countries it is a legal requirement) for the terms agreed upon to be embodied in a written contract. Thus, any point which has been discussed between the parties during negotiations would be expected to find its place in the written contract. It is surprising that one or even bath the parties will be satisfied with a document which does not, in detail, express the intentions hammered out and agreed upon during negotiations.

Of course, if serious disagreement should arise, recourse will be had to relevant correspondence, notes of conversations or the understanding of the intermediary at the time, and usually some sort of compromise is reached.

But why should that sort of difficulty arise, when a few hours of study and consideration of the draft contract would lead to further exchange of views and avoidance of ambiguity.

The answer to that question is that quite often one party will believe that the draft being considered has the authority of a standard policy form, such as is used for Fire, Accident or other recognised class of insurance.

This is not necessarily the case. Usually the draft contract is prepared by the Reinsurer or Broker acting in good faith. There will be clauses which have stood the test of time and which the Reinsurer would be reluctant to change and other clauses may be quite optional and expressed in a particular form of words because it is what the person drafting the contract understood to be the intention expressed during negotiations.

ln either case a much healthier and happier atmosphere exists if points of difference are discussed before a controversial claim arises.

So, my endeavour in the notes set out below is to draw attention to matters which seem to me to be important and might give rise to disappointment if not fully understood by both parties at the time of signature of the contract.

It will be seen that I have avoided any comments on the situation which might arise in the event of a Company going into liquidation. ln such difficult circumstances, the judiciary in the particular country may be expected to direct the manner in which any question is to be resolved.

Excess of Loss Reinsurance: review of standard clauses

(Fire and Allied Perils)[1]

by

ERIC A. PEARCE

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[1] Nous avons demandé à M. Eric A. Pearce de bien vouloir faire une étude des clauses d'un traité en excédent de sinistre. Il nous remet le texte aujourd'hui. C'est avec plaisir que nous le présentons à nos lecteurs, qui en apprécieront la précision. C'est la qualité que l'on reconnaît à notre correspondant sur la place de Londres. Il y jouit de la réputation d'un excellent technicien et d'un honnête homme.

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Article 1. Scope of Cover

There are almost as many variations of this Article as there are contracts of excess of loss reinsurance. However a basic model might read as follows: —

This Agreement, subject to the exclusions hereinafter appearing, shall apply to all policies or contracts of insurance or reinsurance in respect of Fire and Allied Perils, as original, (hereinafter called "policies") underwritten by the Company in Canada.

The importance of this clause cannot be over-emphasized because if it is not correct in detail, the Company may not be enjoying the protection which it believes it has, or the Reinsurer may be granting much wider cover than was contemplated.

The check list should include the following:

(a) In which territories does the Company operate? It might be helpful to submit the clause to the Agency Manager for his consideration. There is always the possibility that there are underwriting agents in various parts of the World whose business should be included within the reinsurance.

(b) Does the Company accept in Canada insurances or reinsurances the subject matter of which may be situated outside Canada? If so, it is advisable to inform the Reinsurer. The tendency is for an Industrial concern to have one insurance underwritten in its country of origin, covering all insurable interest at home and abroad. The Reinsurer is fully aware of this tendency, but nevertheless he might be a little surprised to receive a claim arising out of an earthquake in Siberia — under a policy underwritten in Canada.

(c) Is it required to include any risk other than Fire and Allied Perils? It is not unknown for certain types of Accident risk to be included in such a policy, at the Insured's request. Similarly some Comprehensive forms give cover which is a far cry from standard Fire. Reinsurance Managers may decide to discuss this fully with the Fire Manager and his underwriters, so as to give detailed (but not limitative) information to the Reinsurer.

It must always be remembered that the Reinsurer may have retrocessions for his own protection, the terms of which may not automatically include all extraneous perils. Accordingly if he is fully informed of the exact requirements of the Company, he can make his own detailed arrangements.

Article 2. Exclusions

It is usual to deal with the exclusions as a separate Article of the contract, although there is no reason why this should not form part of the Article expressing the scope of cover.

The standard exclusions are:
(a) War and Civil War
(b) Nuclear Incident.

It is probable that such exclusions appear in the Company's policies. In that case it is sound practice to use the identical text in the reinsurance contract. This should ensure that if at a later date the Company is required to settle a claim which many Insurers might have believed to be excluded, the Reinsurer will probably feel equally involved.

In some instances claims arising in certain territories are excluded. Naturally this is linked with the territorial scope dealt with in a previous Article. The exclusion may appear at the request of the Company because it has separate arrangements for such territory. However it may be at the request of the Reinsurer because the terms applicable in one area are not necessarily applicable in another, or because of the Reinsurer's existing commitments in a given area, or indeed for a variety of reasons.

It is usual to exclude excess of loss reinsurances accepted by the Company. Indeed, the protection of excess of loss acceptances does require special treatment.

Some years ago it was a generally accepted theory that excess of loss reinsurance must be retroceded on a quota share basis and most excess of loss reinsurers arranged proportional treaties for this purpose. The reasoning behind this theory was that as the excess premium was only a small part of the gross premium, an excess premium when calculated on an excess premium would be quite inadequate.

One can visualise examples where this theory would be true, as one can equally well imagine circumstances in which the excess of loss retrocession premium would be exaggeratedly large.

Be it said that at the present time a great number of excess of loss reinsurers are protected on an excess of loss basis. Nevertheless the rates for such contracts can be satisfactorily assessed only when the retrocessionnaire has full details of the reinsurer's portfolio and underwriting principles.

The contracts may make provision for other exclusions but these will probably be particular rather than general, and the exact wording of such exclusions will almost certainly have been agreed in writing between the parties at an early stage.

Article 3. Deductible and Limit of Liability

The following is a typical example of this Article:

1. The Reinsurer agrees for the consideration hereinafter appearing to pay to the Company the ultimate nett loss which the Company shall become liable to pay and shall pay in excess of C$50,000 (fifty thousand Canadian Dollars) ultimate nett loss on account of each and every occurrence involving policies reinsured hereunder.

2. The liability of the Reinsurer in respect of each and every occurrence shall be limited to C$100,000 (one hundred thousand Canadian Dollars) ultimate nett loss, subject to the terms of Article 10 below.

It will be noted that this Article introduces two phrases which appear in the contract for the first time, namely:

(a) ultimate nett loss
(b) each and every occurrence.

Both are of the greatest importance and each will be dealt with as a separate Article.

Attention is drawn to the phrase "liable to pay". This emphasises that the Reinsurer cannot have any greater liability than that which the Company would have had, if the Company were not reinsured. The intention, inter alia, is to make clear that the Reinsurer is not liable for any ex-gratia or over-generous payments which the Company may see fit to bestow on its Insured. This is sometimes elaborated in other Articles of the contract, but there are two main considerations involved.

The first is that if a loss exceeds the deductible, the Reinsurer is liable for the remainder (subject to paragraph 2 of the Article quoted above). That being so, it might be felt that a Company could be tempted to make rather lavish claims settlements when its own share was exceeded.

This position is quite different from that which exists under a quota share or surplus treaty. In such proportional contracts, if the Company has retained only 10% of the risk it has 10% of the premium (subject to ceding commission) and will pay 10% of losses, including 10% of any spectacular ex-gratia payments.

One must bear in mind that the Reinsurer does not have the same interest in pleasing the Insured as does the Company. Those who have been involved in claim settlement may have encountered at least one Insured, who at a given moment in the negotiations lets it be known that to stretch a point beyond the reality of the contract and to allow something more than the proper indemnity, could result in other, more desirable business flowing to the Company. This could be an incentive to the Company, but would not necessarily be of any interest to the Reinsurer.

Naturally, there must be room for negotiation, and the Reinsurer knows that the Company must be commercially minded in a hard competitive world, but the Reinsurer does wish to have the absolute right to be consulted and for his agreement to be obtained before ex-gratia payments are made.

The second point is that the Reinsurer is reminding the Company that the latter is by contract handling the claim for both of them and as such must use the same diligence and skill whatever the amount of

the claim. Without such a firm reminder as the words "liable to pay" there might be a slackening of interest in a claim where the deductible is only a relatively small part of the whole loss.

The phrase "and shall pay" also has its importance. To collect from the Reinsurer, it is not sufficient merely to be liable. There must be physical settlement of the claim. At one stage the phrase used was "and shall pay in cash" and this no doubt still exists in a number of long standing contracts. The words "in cash" were dropped when it became evident that this idea was divorced from reality, that claims
218 may be paid by cheque or by replacement, but are rarely paid in cash.

Naturally, in practice, notwithstanding the use of the words "and shall pay" it is usual for the Reinsurer to assist the Company by making prepayment to the Company of the Reinsurer's share of large claims. It is of no interest to the Reinsurer to force the Company to delve into its reserves, possibly to dispose of investments, merely to fill a gap, when the Reinsurer will in any case be required to provide the money without delay. So this is really one of those instances where a principle has been established and maintained, but where the recognition of common interest provides a practical solution to a problem.

In some contracts the liability of the Reinsurer is limited to a percentage of the loss, 90% or 95% for example. In such cases the relative clauses are altered to read:
(in paragraph 1) — to pay to the Company, 90% (or 95%) of the ultimate nett loss —
(in paragraph 2) — shall be limited to 90% (or 95%) of Canadian Dollars —.

The reference to Article 10 at the end of paragraph 2 of the Article quoted above, will apply only in those cases where there is an aggregate limit of liability of the Reinsurer. This is usually referred to as "reinstatement". It is sometimes dealt with in further paragraphs of this Article, but is perhaps more conveniently written into the contract as a separate Article. This is the method used in this review, as will be seen in Article 10, below.

Article 4. Each and Every Occurrence

The following Article is one which has been developed over the years, and is now freely accepted by many Companies and Reinsurers alike:

1. Except as stated in paragraphs (2), (3) and (4) below the expression "each and every occurrence" as used herein shall be understood to mean each and every occurrence or series of occurrences arising out of one and the same event irrespective of the number of policies involved.

2. As regards the risks of Tornado Hurricane Windstorm Cyclone and Hail the term" each and every occurrence" used in this Agreement shall mean the sum total of all losses of the Company arising out of one atmospheric disturbance and happening during any period of 72 (seventy two) consecutive hours. The Company may designate the moment from which the aforesaid period of 72 (seventy two) consecutive hours shall or be deemed to have commenced. The number of 72 (seventy two) hour periods shall not be limited, but any such period shall not commence within the period of any previous such occurrence.

3. As regards the risk of Earthquake the term "each and every occurrence" used in this Agreement shall mean the sum total of all losses of the Company arising out of such risk and happening during any period of 72 (seventy two) consecutive hours. The Company may designate the moment from which the aforesaid period of 72 (seventy two) consecutive hours shall be deemed to have commenced. The number of 72 (seventy two) hour periods shall not be limited, but any such period shall not commence within the period of any previous such occurrence.

4. As regards the risks of Strikes, Riots, Civil Commotions and Malicious Damage, the term "each and every occurrence" used in this Agreement shall mean the sum total of all losses of the Company arising out of such risks and happening during any period of 72 (seventy two) consecutive hours within the confines of one city town village or administrative district. The Company may designate the moment from which the aforesaid period of 72 (seventy two) consecutive hours shall be deemed to have commenced. The number of 72 (seventy two) hour periods shall not be limited, but any such period shall not commence within the period of any previous such occurrence relating to the same city town village or administrative district.

For the purpose of this paragraph a city or town shall be deemed to include adjoining suburban areas, notwithstanding that

each suburb may be under a separate local government administration.

The above may seem rather verbose in comparison with other Articles intended to achieve the same purpose. However there is here expressed a most important practical application of the reinsurance and a few additional words may not be wasted if they help to provide a clearer understanding between the parties.

It is essential to draw attention to the difference between

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(a) the "per risk" reinsurance,
and (b) the "per occurrence" reinsurance.

Perhaps this is most easily understood by a simple example:

Suppose that a Company insures twelve houses, each considered to be a separate risk and each insured for C$60,000. Contrary to all probability, all are completely destroyed by a peril insured against.

Under a reinsurance based on (a) above, each house is the subject of a separate claim against the Reinsurer and the deductible would apply separately to each claim.

Under a reinsurance based on (b) above. the whole loss of 12 x 60,000, being C$720.000 forms one claim against the Reinsurer and the deductible would apply only once, to the whole amount of the claim. It is to this latter form of reinsurance that the following remarks apply.

It will be readily appreciated that as insurance policy forms became more and more complicated and were extended to include further perils, doubts must have arisen as to when an "occurrence" started and ended. It is believed that the idea of an "Hours Clause" first arose out of a claim following a storm during which a number of entirely separate buildings were seriously damaged. The question was raised immediately as to whether each building was to be treated as an occurrence or whether the storm should be considered as such.

The clauses set out above have developed over the years from the original concept of an "Hours Clause" and the developments have not always been to the advantage of the Company, or resulted in a greater clarity.

In paragraph 2, the words "arising out of one atmospheric disturbance" were introduced some years ago, and whilst this is apparently a protection for the Reinsurer, it may seem to nullify much of the thinking which produced the "Hours Clause" in the first place, for it raises once again the doubt as to what is one atmospheric disturbance, and so what is "one occurrence".

It is interesting that one important group of reinsurers when quite recently preparing basic standard clauses for excess of loss reinsurance, did not include the "one atmospheric disturbance" limitation in their draft of the equivalent of paragraph 2 above.

In relation to paragraph 4, there has been much controversy regarding the area limitation. It was argued at one time that disturbances such as riots and strikes in one area were unrelated to those in another and therefore each should be treated as a separate "occurrence". There are perhaps few people who would agree with that argument to-day.

In any case, many Reinsurers wished to reduce the amount of loss likely to arise in a given area and many endeavours were made to find an acceptable formula. One idea was to predetermine zones of a stated number of square miles, whilst another suggestion was that all losses within the boundaries of each electoral constituency, or other independently determined area, should be considered as one "occurrence".

In many cases both parties became very uneasy as to what might result from such untried definitions, and finally the "city town or village" became generally accepted, although without any great enthusiasm on either side.

Particular attention is drawn to the inclusion above of the words "administrative district", for although every square inch of a civilised country is "administered" in some form or another, there are vast tracts of land even in greatly over-populated countries, which are not within the confines of a city town or village; for example, extensive farm or forest land. Nevertheless these latter can be seriously damaged by persons of malicious intent.

It is surprising that in the basic standard clauses referred to above, the authors who were so conciliatory in the matter of atmospheric disturbance are not so in the matter of civil disturbance. Their clause relative to riots etc., applies "— within the limit of one city town or village—" and in a governing clause included in the Article the inten-

tion is re-asserted and emphasised by the words "— no individual loss from whatsoever insured peril which occurs outside these periods or areas shall be included —".

It is essential to the very nature of reinsurance that each "Hours Clause" should be interpreted with good sense and understanding on both sides.

The intention is to assist in the smooth and speedy settlement of claims, not to provide a catchment for unlikely interpretations. For example, it will be noted that neither frost nor flood (other than in conjunction with wind etc.) are referred to in the above clauses, but both these natural phenomena produce great numbers of claims which in the aggregate can be costly. There is, no doubt, a case for saying that it is relatively easy to determine what constitutes "one occurrence", at least in a country where a frost lasts for two or three days at most and a flood subsides in a few hours. But what of the countries where the frost lasts for months and the floods continue for weeks?

It is worth considering the application of the "Hours Clause" where the original losses are likely to occur in what can best be described as "waves". The best example is that of strikes, riots etc. These are man-made perils, there is no pattern and one can imagine a slow start; a few windows broken, then a store burned — building up to millions of dollars of damage in one night and then tailing off, to start again days or weeks later.

Many years ago the writer was asked to assist in the negotiation of the settlement of claims made against the Reinsurer under a clause similar to paragraph 4 above, without the "city town etc." limitation.

All the original claims, which occurred over a period of some weeks, were settled by the Company during the following year or eighteen months, so the point was reached where the amount of the Company's disbursement was not in doubt, nor was there any serious doubt as to the date of each original loss, although in some cases it was necessary to have recourse to police records to determine when the particular damage arose. What was in doubt was how to determine what constituted "one occurrence" and this was of vital importance because of the "wave" effect referred to above, and the relatively long duration between the commencement of the destruction and the final pacification.

Finally it was agreed with the Reinsurer that the Company should choose the moment for the beginning of each "occurrence" (subject

naturally to no overlap) even if there were a lapse of time between the end of one occurrence and the beginning of the next.

There was a feeling that although the Company was free to choose the beginning of the first "occurrence" each "occurrence" thereafter should commence immediately upon the ending of the previous "occurrence".

In the meantime there have been variations of this clause, one making it a condition that the first "occurrence" must commence at the same time as the Company's first loss. The above more flexible basis allows the Company to choose the moment from which the "occurrence" commences.

Presumably the difference of intention is that if the Company has a ten dollar loss on Day 1, nothing on Day 2, heavy losses on Days 3, 4 and 5 with nothing on Day 6, in the first case the "occurrence" must commence on Day 1 to include Days 2 and 3; whereas in the second case the Company could ignore Day 1 and commence the "occurrence" on Day 3 to include Days 4 and 5, thus avoiding the necessity of spreading the days of heavy loss over two periods.

The "Hours Clauses" set out above each show the period as being 72 hours. In fact the period is a matter for negotiation with the Reinsurers, and the Company's preference will depend upon the amount of cover which it has.

Such cover may be in one contract or in two or more successive layers. In the latter case, care must be taken to ensure that each layer has the same "Hours Clauses".

Provided that the Company has sufficient cover to meet the most unlikely contingency, the Company will prefer the longest available period, which brings all losses into one ultimate nett loss calculation, and so will require the Company to bear only one deductible.

On the other hand the Company which has only very limited protection will opt for a shorter period, so that in some circumstances it could hope to apply its "each and every occurrence" limit more than once, even although this would mean bearing the deductible at least twice. In such circumstances the Company must pay careful attention to its reinstatement condition, to ensure that sufficient cover remains for future protection. (See Article 10, hereafter).

(*To be continued*)