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REINSURANCE DIALOGUE

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REINSURANCE DIALOGUE

between Christopher J. Robey
and David E. Wilmot

February 16, 1997

Dear Mr. Wilmot,

Extra contractual obligations clause and excess of policy limits clause

There is really nothing in what you write on these two clauses with which I can disagree, so I shall limit myself to some additional comments.

You draw a clear distinction between extra contractual obligations claims and claims in excess of policy limits by distinguishing against whom the claim is made – the former against the insured and reimbursed by the insurer, the latter against the insurer itself. This is clear and unlikely to cause dispute, although one can imagine an award cutting straight through to the insurer in a third party case when it could have legitimately been made against the insured. Nonetheless, the excess of policy limits clause foresees this possibility and includes it within its definition.

Although you draw almost as clear a distinction between extra contractual obligations and punitive damages, a distinction justified by current legal practice, it is easy to see this distinction eroding as time goes on. The difference between bad faith and wantonly reprehensible behaviour is after all just a point on a continuous line.

The authors:

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David E. Wilmot is Manager and Chief Agent for Canada, Frankona Reinsurance Company.

Claims co-operation clause

One aspect which you do not deal with is the possibility of the reinsurer's involvement in the actions which led to the excess of policy limits loss or the extra contractual obligation. Most excess of loss contracts contain a claims co-operation clause rather than a simple claims advice clause requiring the reinsurer to follow the fortunes of the ceding company. Under the claims co-operation clause, the reinsurer is kept informed of the actions of the ceding company. The reinsurer can recommend particular actions to the ceding company whenever it wishes, since it is after all the reinsurer's money at risk. In the more difficult circumstances likely to lead to one of these types of claims, the ceding company will often consult with the reinsurer in determining the course of action it will take. This is obviously more complicated when several reinsurers are involved on the contract, since they may not all agree, but the ceding company will always do its best to meet the reinsurers' wishes – to do otherwise could result in the reinsurers' refusal to pay the full amount of the claim.

If the ceding company has to pay an additional amount because it followed the recommendation of the reinsurer, it seems only reasonable that the reinsurer should reimburse it for that extra amount. The ceding company would also have caused damage to its reputation, something the reinsurer will probably escape because it is hidden by the privity of the reinsurance contract. In such circumstances, it would be reasonable for the reinsurer to pay 100% of the resulting damages, not just 80% as is frequently the case under the extra contractual obligations clause.

Punitive damages

The reinsurer should also reimburse the ceding company for punitive damages it has to pay if they are the result of actions recommended by the reinsurer, even if they are specifically excluded from the contract. Ideally this should be agreed before the actions are taken, but the ceding company may be in a weak position to obtain such a commitment from the reinsurer when the alternative is the possibility that the reinsurer refuse the claim because the ceding company acted against its recommendation.

Obviously, disagreements of this type are rare and suggest a relationship between the parties which has deteriorated substantially from what each had anticipated when entering into the contract. However, when all is going well, disagreements can usually be settled without reference to the written contract – it is when they are going badly that the contract must be precise. By this measure, the extra contractual obligations clause and punitive damages exclusion currently in use could do with some attention.

Definition of a property occurrence

We discussed the definition of an occurrence for reinsurance purposes in our first exchange, in the July and October 1990 issues of this magazine, but the storm in British Columbia over last year-end has caused me to think about some unusual circumstances which the usual definition can produce.

The timing of the British Columbia storm, right over year-end, resulted in the rare use of the "ongoing occurrence" provision which usually appears in the clause setting out the term of the contract – that all losses from an occurrence which begins during the term of the contract are covered by the contract, even if the occurrence continues after expiry of the contract.

This is a sensible provision protecting the ceding company from being denied coverage because not enough damage was done from the same occurrence either side of January 1 to exceed the deductible under its reinsurance protection. By accumulating all the damage in the year the occurrence began, the ceding company avoids losing its protection over a technicality.

Reinstatement premium

An occurrence which runs over the year end raises an interesting question about reinstatement, however – if there is no possibility of a further loss because the contract has expired, is the reinstatement premium still payable. The additional premium is not payable as a direct result of the loss but is consideration for the reinstatement of cover reduced by the loss. If the reinsured loss occurs after expiry because the contract deductible was not reached before year end, even though the occurrence had begun, can the contract be reinstated? Although the normal contract provision makes reinstatement obligatory, a condition which is impossible to meet cannot reasonably be enforced. If there can be no reinstatement, there is no reinstatement premium.

When reinstatement premiums were calculated pro-rata as to time as well as amount, this was not a problem, since the result of the calculation would have been zero anyway. However now that they are usually calculated at 100% as to time and pro-rata as to amount only, the ceding company could be asked to pay its full reinsurance premium over again to buy nothing, not an equitable situation.

In your letter in the July 1990 issue of Assurances, you point out that, in practice, reinsurers look at the reinstatement premium as more than a premium paid to buy additional cover. I agreed with much of what you said in my response in the October 1990 issue and, if we were right then, a reinstatement premium would certainly be payable in the circumstances described above. But that is not how the contract reads and, if reinsurers want something different than what the contract says, they should have changed the contract by now. It is highly questionable, therefore, that the reinsurer is entitled to a reinstatement premium when the contract cannot actually be reinstated.

New underlying contract

Under the normal time clauses, the ceding company decides when its occurrence begins, so long as it is not earlier than its first recorded loss from the occurrence. Thus, if the ceding company had arranged protection at a lower level in the new year than in the old, it could elect to begin its reinsurance occurrence on January 1, on the basis that it can then claim reinsurance protection which it would not have had the previous year.

Of course, insurers rarely reduce deductibles, but it could happen in several circumstances. In this soft reinsurance market, it could simply be to take advantage of highly competitive pricing offered by reinsurers. Perhaps the protection existed in the previous year, but as part of an inter-group cover, and the insurer preferred to collect on the open market – again the soft reinsurance market could have made the open market placement more attractive to the group. Alternatively, the company may have just Canadianised its program, perhaps because of a change in policy at its parent or because it had been bought by new Canadian owners.

Non-concurrency

If the entire reinsurance program is new, protection under all layers will begin January 1, but what if only the underlying layer is new and the overlying portion of the program is a continuation of that of the previous year? Is the ceding company obliged to choose the same starting date for its occurrence under all layers, or can it choose different ones in order to maximise cover?

There is no contractual requirement that the same starting date be used for all layers of a program, although there would not normally be any reason to pick different dates. However one is described above. Another could be the reduced availability of cover in the year the occurrence began because of near exhaustion of reinstatements from earlier occurrences affecting the bottom layer but not others.

In such circumstances, there would not seem to be any reason, either contractual or in good faith, why the ceding company cannot maximise its recoveries by having different starting dates for the occurrence under different layers.

Since each layer is a different contract, even when the same reinsurers appear on several, the ceding company is entitled to apply the terms of each one independently in deciding how it will recover.

The ability to choose different coverage periods for what is in reality the same loss is not the only way in which non-concurrency in the occurrence definition can produce unusual results. Although concurrency is normally desirable, there could be circumstances when non-concurrency would be to the ceding company's benefit. An example would be when particularly attractive terms were available on one layer, but only if the ceding company accepts a longer time period in the definition of a type of occurrence – 168 hours instead of 72 for windstorm, for example. The ceding company could thus deliberately find itself with different occurrence definitions on different layers of its program for the same storm.

Different definitions are also found in the reinsurance of different classes, for example a marine cover may well have a 168 hours definition for windstorm, while a property cover has 72 hours. Normally this does not result in non-concurrency, but if both marine and non-marine are covered in the same program, with a specific marine cover inuring to the benefit of the main program, unusual circumstances can occur.

A loss which exhausts the underlying marine cover in 72 hours would not be reinstatable in that cover for a further 96 hours. However cover at that level would be available from the main program, which can be reinstated after 72 hours. The main program would then pay the second occurrence from the event without the benefit of the more specific marine cover. So long as the reinsurers of the main cover are aware of the terms of the marine cover, this is a legitimate use of the reinsurance.

Of course, none of these situations would arise if we stopped trying to define an occurrence and went back to using proximate cause to do the job for us.

Yours sincerely

Christopher J. Robey