Direct Your Learning

5

Common Reinsurance Treaty Clauses, Part II

Educational Objectives

After learning the content of this assignment, you should be able to:

- Describe the purpose of each of the following reinsurance treaty clauses:
  - Commencement and termination clause
  - Reports and remittances clause
  - Excess of policy limits clause
  - Extra-contractual obligations clause
  - Territory clause
  - Self-insured obligations clause
- Describe the purpose of each of the following ancillary agreements and endorsements:
  - Special acceptance agreement
  - Cut-through endorsement
  - Guarantee endorsement
  - Indemnity agreement

Outline

Common Reinsurance Treaty Clauses, Part II

5

OTHER COMMON TREATY CLAUSES

Reinsurance treaties often include common clauses that vary based on the type of reinsurance used or that provide specialized coverage. Although the titles of these clauses are commonly used, their provisions may differ significantly among reinsurance agreements, depending on the needs of the parties to the agreement.

These common clauses vary by type of reinsurance:

- Commencement and termination clause
- Reports and remittances clause

These common clauses provide specialized coverage:

- Excess of policy limits clause
- Extra-contractual obligations clause
- Territory clause
- Self-insured obligations clause

Although most of these clauses can be used both for facultative and treaty reinsurance, the clauses discussed are in a treaty context. The sample clauses are for illustrative purposes only and should not be relied on to construct an actual treaty.

Commencement and Termination Clause

The commencement and termination clause states the reinsurance treaty's duration and the circumstances that would trigger its termination. In many treaties, this clause may also specify the basis of attachment. Clearly specifying the beginning and end of the reinsurance relationship is critical in determining the loss exposures covered by the treaty. For example, a primary insurer may determine that the terms of its commencement and termination clause do not encompass all of its loss exposures and that, as a result, alternative reinsurance arrangements must be made.

Two important elements of the commencement and termination clause are the normal term of the treaty and the circumstances under which the treaty can be canceled.

Normal Term

The commencement and termination clause establishes the term of coverage, specifying effective times and dates.

The effective time for commencement of coverage is usually 12:01 a.m. standard time. Under pro rata or excess of loss property treaties, standard time typically pertains to the time zone at the location of the loss exposure. Under casualty excess of loss treaties, standard time typically pertains to the time zone at the mailing address of the named insured shown in the declarations page in the original policy. Under clash cover (liability insurance) and catastrophe treaties (property insurance), standard time typically pertains to the time zone at the primary insurer's home office. The time of termination is also usually 12:01 a.m. standard time, with the time zone applying in the same manner as for commencement. To be clear, treaties should specify exactly what time and time zone apply.

The termination of coverage will depend upon the type of contract. Reinsurance treaties can be written on either a continuous or term basis:

Continuous contract

A reinsurance treaty that remains in effect until canceled by one of the parties to the treaty.

- **Continuous contract**—Wording in the termination clause may state, "This contract shall continue in force until terminated." Termination of a continuous contract usually requires ninety days' notice, and termination can occur (1) at any time, (2) quarterly, (3) semiannually, or (4) annually. The primary insurer and reinsurer generally negotiate the length of the notice period.

Term contract

A reinsurance treaty that terminates on a specific date.

- **Term contract**—Wording in the termination clause may state, "This agreement shall remain in effect from 01/01/20X3 until 01/01/20X4." Generally, a term contract does not terminate until the expiration date, except by mutual agreement of the parties. Term contracts usually do not provide run-off of existing policies, and the primary insurer will typically want to purchase coverage for any in-force loss exposures at the expiration date of the treaty.

When treaty agreements are written as term contracts, the expiration date concludes the reinsurance agreement, and the reinsurer no longer pays any losses that occur or claims made after the treaty's expiration date. However, if treaties are on a risks attaching basis, the reinsurer must consider whether it will have any further responsibility or liability for losses arising from the policies covered under the treaty at the treaty's termination.

These treaties usually provide for termination on either a run-off or cut-off basis:

Run-off basis

A reinsurance treaty provision that allows all policies in force at the date of termination to be covered under the treaty until they expire.

Cut-off basis

A reinsurance treaty provision that allows the reinsurer's responsibility for losses occurring under the primary insurance policies to end at the treaty's termination date.

- **Run-off basis**—The reinsurer retains the unearned premium represented by in-force policies and remains liable for covered losses under those policies until the expiration of the primary insurance policies plus any additional time specified in endorsements made to those policies.
- **Cut-off basis**—Unearned premiums held by the reinsurer for in-force policies are returned to the primary insurer. The primary insurer has no

reinsurance protection for new losses arising from these policies, and the primary insurer's balance sheet must be adjusted to reflect the additional liability for the unearned premiums and any associated loss reserves.

When primary insurers replace treaties, they should review the effective time and terms of the expiring treaties to ensure that no gaps in coverage exist between them and the new treaties. The more comfortable the reinsurer is with the primary insurer and with the business covered, the less concerned the reinsurer is about its ability to cancel quickly. Whether the treaty can be canceled on a run-off or cut-off basis is determined when the treaty is drafted. Both parties should carefully consider what their needs might be if the treaty is canceled.

The exhibit shows a continuous contract commencement and termination clause with the primary insurer's option of run-off or cut-off liability at termination. See the exhibit "Sample Commencement and Termination Clause."

Sample Commencement and Termination Clause

57 A

COMMENCEMENT AND TERMINATION

This Contract shall incept at 12:01 a.m. Local Standard Time (month), (day), (year) at the location of the risk and shall remain in force for an indefinite period, but either party shall have the right to cancel as of (month), (day), (year) or any (month), (day) thereafter by giving at least ____ days prior written notice by certified or registered mail.

In the event either party cancels in accordance with the paragraph above, the Reinsurer shall participate in all policies ceded within the terms of this Contract written or renewed by the Company after receipt of notice of cancellation but prior to termination.

In the event of the termination of this Contract, at the Company's option:

A. The Reinsurer shall remain liable for all cessions in force at termination of this Contract; however, the liability of the Reinsurer shall cease with respect to losses occurring subsequent to the first anniversary, natural expiration or cancellation of each policy ceded, but not to extend beyond 12 months after such termination; or

B. The Reinsurer shall be relieved of all liability hereunder for losses occurring subsequent to termination of this Contract.

The Reinsurer shall refund to the Company the unearned reinsurance premium applicable to the unexpired liability (calculated on a pro rata basis), less the commission allowed by the Reinsurer thereon at conclusion of the runoff if option a) above is elected, or at termination if option b) above is elected. The Reinsurer will continue to be liable for its proportionate share of the outstanding losses (reported or unreported) on policies ceded hereunder with a date of loss prior to the conclusion of the runoff, or termination, as the case may be.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/contractword/Commencement%20and%20Termination%20BRMA%2057A-J%20see%20BRMA63%20also.doc (accessed November 6, 2012). [DA05186]

Cancellation Circumstances

A reinsurance treaty can be canceled through any of these means:

- Formal notice of cancellation
- Mutual consent
- Liquidation of either party
- Sudden death provision
- Special termination clause
- Nonpayment of balances provision

The commencement and termination clause usually requires ninety days for formal notice of cancellation. The clause specifies a mailing method, such as certified mail or registered mail, to avoid confusion about when notice was mailed. Although not specified in the treaty, customary practice accepts the actual mailing (appropriately postmarked) on or before the notice date as constructive receipt of the notice by the other party. That practice precludes the performance of a third party (such as the postal service) from affecting compliance with contractual provisions.

Reinsurance treaties can be canceled by the contracting parties' mutual consent. The parties can agree to cancel the treaty effective immediately or on some other date. For example, cancellation by mutual consent can arise when the primary insurer sells fewer policies than it or the reinsurer had anticipated and the reinsurance treaty is not needed or not cost-effective to continue. Under such circumstances, mutual termination of the reinsurance treaty serves the interests of both the primary insurer and the reinsurer. Cancellation by mutual consent does not require any specific wording because any contract can.be canceled by mutual consent.

Although the commencement and termination clause may not specifically address liquidation, usually neither party objects to cancellation when one party's business is terminated. Many states have a statute requiring cancellation in the event of liquidation.

The commencement and termination clause may include a sudden death provision. Sudden death provisions allow one party, usually the reinsurer, to cancel the reinsurance treaty on a cut-off basis if specific events occur. A sudden death provision may be included in reinsurance treaties with primary insurers that are newly formed, have limited written premium, or have limited financial resources. See the exhibit "Sample Sudden Death Provision."

Sample Sudden Death Provision

The Reinsurer (and the Company) shall also have the option to terminate this Agreement in whole or in part for the reasons set forth below:

1. The sale, merger, or acquisition of the Company by or with any other party or the sale or change in controlling interest of the Company so as to produce a loss in control over conduct of the business by the current owners and/or management, except any change of control or ownership within any insurance holding company system that effects no change in ultimate controlling party.
2. A reduction of the paid-in capital of the Company for any reason whatsoever.
3. The appointment of a receiver, administrator, trustee, or conservator for the Company or the commencement of any liquidation, rearrangement, or bankruptcy proceeding against the Company.
4. Should the Company at any time reinsure its minimum or net retention on any class of business to which this Agreement applies.

The Company shall immediately notify the Reinsurer in writing, giving details to the extent of its knowledge thereof, of the particulars of any of the events set forth in subparagraphs 1, 2, 3, or 4. The Reinsurer may commence termination proceedings within thirty days of the receipt of such notice, by sending to the Company by registered mail to its principal office, notice stating the time and date when termination shall be effective (not less than thirty days after the date of mailing such notice). If the Company fails to immediately notify the Reinsurer of any of the aforementioned events, the Reinsurer may commence such termination at any time after it has acquired knowledge of any such event. Upon termination of this Agreement for any of the reasons set forth in subparagraphs 1, 2, 3, or 4 above, the Reinsurer shall not be liable for claims or losses resulting from occurrences taking place after the effective time and date of termination. (In such an event, the Reinsurer shall return to the Company the reinsurance premium unearned, calculated on the monthly pro rata basis, less the commission previously allowed thereon, and less any other amounts due from the Company to the Reinsurer.)

[DA05187]

Immediate termination is often included in sudden death provisions for reasons such as these:

- Change in the primary insurer's ownership, management, or control—Because primary insurer management is an important underwriting characteristic, reinsurers often want the option to cancel the reinsurance treaty if management of the primary insurer changes after commencement. For example, the new management may choose a different underwriting direction that involves the cession of loss exposures not anticipated when the reinsurance treaty was negotiated. While difficult to quantify, reinsurers want business relationships with primary insurers in which they have confidence. The sudden death provision allows the reinsurer to review the primary insurer's new management and cancel the reinsurance treaty if such action is considered appropriate.
- Reduction in the primary insurer's paid-in capital or policyholders' surplus—Reinsurers usually avoid financially impaired primary insurers.

The reduction in a primary insurer's financial rating that typically accompanies a financial impairment often limits the primary insurer's marketing access to quality insureds. Also, financially impaired primary insurers are usually unable to remit reinsurance premium due to the reinsurer on a timely basis, if at all. The sudden death provision can specify a reduction either in paid-in capital or of policyholders' surplus as the type of financial impairment that would allow the reinsurer to cancel the reinsurance treaty.

- Insolvency of the primary insurer—Reinsurers typically want to cancel the reinsurance treaty immediately if their primary insurers become insolvent. State insurance regulators' initial response to solvency concerns is to stop the primary insurer from issuing new policies—a response that usually makes the reinsurance treaty inoperative. As a consequence of the primary insurer's insolvency, key employees of the primary insurer often find other employment opportunities, thereby depriving the primary insurer of personnel resources the reinsurer considered important when negotiating the reinsurance treaty. The sudden death provision gives the reinsurer a convenient contractual means to terminate the treaty regardless of regulatory action.
- Reduction of the primary insurer's net retention—Reinsurers usually want the option to cancel the reinsurance treaty if it is discovered that the primary insurer has reduced its net retention through another reinsurance agreement. Reinsurers want the primary insurer to have a significant financial stake in the profitability of the reinsured policies. A reduction in the primary insurer's net retention implies that the primary insurer believes the ceded loss exposures will be unprofitable. The sudden death provision gives the reinsurer the right to cancel the reinsurance treaty if the primary insurer's net retention is reduced.

Special termination clauses operate similarly to sudden death provisions except that either the reinsurer or the primary insurer has the option of terminating the reinsurance treaty if specific criteria are met. See the exhibit "Sample Special Termination Clause."

The nonpayment of balances provision provides the reinsurer with a contractual right to cancel the reinsurance treaty on a cutoff basis if the primary insurer fails to pay balances owed to the reinsurer in a timely fashion. A reinsurer may insist on including this provision in reinsurance treaties with primary insurers that have a history of being slow to pay balances owed to reinsurers. See the exhibit "Sample Nonpayment of Balances Provision."

Reports and Remittances Clause

The reports and remittances clause requires the primary insurer to submit information to the reinsurer so that net balances owed to each party can be calculated and remitted and so financial statements can be completed. The reports and remittances clause used in pro rata reinsurance typically

Sample Special Termination Clause

63 A

SPECIAL TERMINATION

Either the Company or the Reinsurer may terminate this Contract at any time by the giving of ______ days notice in writing to the other party upon the happening of any one of the following circumstances:

(a) A State Insurance Department or other legal authority orders the other party to cease writing business, or

(b) One party has become insolvent or has been placed into liquidation or receivership (whether voluntary or involuntary), or there has been instituted against it proceedings for the appointment of a receiver, liquidator, rehabilitator, conservator, or trustee in bankruptcy, or other agent known by whatever name, to take possession of its assets or control of its operations, or

(c) One party's policyholders' surplus has been reduced by whichever is greater, either 50% of the amount of surplus at the inception of this Contract or 50% of the amount at the latest anniversary, or has lost any part of, or has reduced its paid-up capital, or

(d) One party has become merged with, acquired or controlled by any company, corporation, or individual(s) not controlling the party's operations previously, or

(e) One party has reinsured its entire liability under this Contract without the terminating party's prior written consent.

In the event of such termination, the liability of the Reinsurer shall be terminated in accordance with the termination provisions of this Contract.

However, if the terminating party is the Company, the Company shall have the right, by the giving of prior written notice, to relieve the Reinsurer of liability for losses occurring subsequent to the date of termination of this Contract. In such event, the Reinsurer shall return the unearned portion of any premiums paid hereunder and the minimum premium provisions, if any, shall be waived.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/contractword/Special%20 Termination%20BRMA%2063A-B%20-%20see%20BRMA%2057.doc (accessed November 6, 2012). [DA05189]

requires the reporting of more information than the one used in excess of loss reinsurance.

The exhibit shows a reports and remittances clause used in pro rata reinsurance. It is appropriate for a treaty on a written premium basis in which the remitting time is different from the reporting time. See the exhibit "Sample Reports and Remittances Clause—Pro Rata Reinsurance."

The exhibit shows a reports and remittances clause for excess of loss reinsurance. See the exhibit "Sample Reports and Remittances Clause—Excess of Loss Reinsurance."

Sample Nonpayment of Balances Provision

Notwithstanding any other provisions set forth in this Agreement, if any amount payable by the Company to the Reinsurer becomes overdue, the Reinsurer may terminate this Agreement at any time in its entirety, by sending the Company by registered mail, or certified mail to its principal office, notice stating the time and date when, not less than thirty days after the date of mailing of such notice, termination shall be effective. Failure on the part of the Reinsurer to exercise this right of termination shall not serve to waive the enforcement of this right for cause thereafter.

Upon termination, the Reinsurer shall not be liable for any claims or losses resulting from occurrences taking place after the effective time and date of termination. The Reinsurer shall return to the Company the reinsurance premium unearned, calculated on a monthly pro rata basis, less any commission previously allowed thereon, and less any other amounts due from the Company to the Reinsurer.

[DA05191]

Sample Reports and Remittances Clause—Pro Rata Reinsurance

45 C

REPORTS AND REMITTANCES

Within ______ days after the close of each ______, the Company will furnish the Reinsurer with a report summarizing the written premium ceded less return premium and commission, losses paid, loss adjustment expense paid, monies recovered, and net balance due either party. In addition, the Company will furnish the Reinsurer a ______ statement showing the unearned premium, the total reserves for outstanding losses including loss adjustment expense, a breakdown by American Insurance Association catastrophic code numbers for paid and outstanding catastrophe losses and loss adjustment expense, and such other information as may be required by the Reinsurer for completion of its NAIC annual statements.

The net balance will be paid within ______ days after the close of the respective ______. Should payment due from the Reinsurer exceed as respects any one loss, the Company may give the Reinsurer notice of payment made or its intention to make payment on a certain date. If the Company has paid the loss, payment will be made by the Reinsurer immediately. If the Company intends to pay the loss by a certain date and has submitted a satisfactory proof of loss or similar document, payment will be due from the Reinsurer twenty-four (24) hours prior to that date, provided the Reinsurer has a period of five (5) working days after receipt of said notice to dispatch the payment. Cash loss amounts specifically remitted by the Reinsurer as set forth herein will be credited to its next ______ account.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/contractword/Reports%20and%20Remittances%20BRMA%2045A-D.doc (accessed November 6, 2012). [DA05192]

Sample Reports and Remittances Clause—Excess of Loss Reinsurance

Within 45 days after the close of each calendar quarter, the Company shall furnish to the Reinsurer a statement of the premium calculation, calculated according to Article _______________. Balances are due and payable with the premium calculation. The Company shall furnish all necessary statistics to allow the Reinsurer to prepare its statutory report.

[DA05193]

Excess of Policy Limits Clause

The excess of policy limits (XPL) clause requires the reinsurer to indemnify the primary insurer for losses in excess of policy limits. Losses in excess of policy limits are the damages awarded against the primary insurer in favor of the insured because of the primary insurer's failure to settle a third-party claim against the insured by reason of bad faith, fraud, or gross negligence. The damages are for losses that would have been covered under the policy had the policy limits been higher.

The XPL clause is usually used in reinsurance treaties covering liability loss exposures and property loss exposures that have bailee liability exposures. XPL clauses may limit the scope of the reinsurance coverage provided by specifically stating that only compensatory and not punitive damages are covered.

An XPL clause usually provides that the original loss and the loss in excess of policy limits constitute one loss. Its inclusion does not generally change the reinsurance treaty limits. However, in anticipation of higher-than-normal limits needed for losses in excess of policy limits, some pro rata treaties increase the treaty limits for these losses. For example, a pro rata reinsurance treaty may have a limit of $1 million and provide for losses in excess of policy limits up to "one additional limit" or $2 million total, a 100 percent increase (subject to a co-participation provision).

XPL clauses usually include a co-participation provision that applies to the losses in excess of policy limits. Reinsurers that include a co-participation clause often also specify that the primary insurer's co-participation percentage cannot be reduced by other reinsurance unless the reinsurance is with an affiliated company of the primary insurer.

Loss adjustment expenses, often a considerable sum in claims involving excess of policy limits damages, are usually shared between the primary insurer and the reinsurer in the same proportion in which they share the loss. If the primary insurer has any other insurance or reinsurance that applies, those recoveries reduce the loss applicable to the treaty.

The exhibit shows an XPL clause for use in a pro rata reinsurance treaty in which the percentage of coverage and limit provided for excess of policy limits coverage are specified elsewhere in the treaty. See the exhibit "Sample Excess of Policy Limits Clause."

Sample Excess of Policy Limits Clause

15 B

EXCESS OF ORIGINAL POLICY LIMITS

This Contract shall protect the Company, within the limits hereof, in connection with loss in excess of the limit of its original policy, such loss in excess of the limit having been incurred because of failure by it to settle within the policy limit or by reason of alleged or actual negligence, fraud, or bad faith in rejecting an offer of settlement or in the preparation of the defense or in the trial of any action against its insured or reinsured or in the preparation or prosecution of an appeal consequent upon such action.

However, this Article shall not apply where the loss has been incurred due to fraud by a member of the Board of Directors or a corporate officer of the Company acting individually or collectively or in collusion with any individual or corporation or any other organization or party involved in the presentation, defense or settlement of any claim covered hereunder.

For the purpose of this Article, the word "loss" shall mean any amounts for which the Company would have been contractually liable to pay had it not been for the limit of the original policy.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/contractword/Excess%20of%20 Original%20Policy%20Limits%20BRMA%2015A-F.doc (accessed November 6, 2012). [DA05194]

Extra-Contractual Obligations Clause

The extra-contractual obligations (ECO) clause requires the reinsurer to indemnify the primary insurer for extra-contractual damages awarded against the primary insurer in favor of the insured because of the primary insurer's bad faith, fraud, or gross negligence in handling a claim. These damages are for losses that go beyond the scope of the underlying policy coverage. The ECO clause is used in reinsurance agreements covering either property or liability loss exposures.

The ECO clause has many of the same provisions as the excess of policy limits clause. For example, both clauses provide for a sharing of losses and expenses between the reinsurer and the primary insurer, specify whether the coverage limit of the treaty increases for these claims, and require that other insurance or reinsurance applicable to the claim reduces the net loss before the treaty is applied. However, the ECO clause may have a higher co-participation percentage, ensuring that the primary insurer is responsible for a greater share of these losses, and the reinsurer may be unwilling to increase the treaty limit for these losses. See the exhibit "Comparison of Excess of Policy Limits and Extra-Contractual Obligations Clauses."

Some ECO clauses designed for use in pro rata reinsurance treaties specify the percentage of coverage and limits provided for extra-contractual obligations elsewhere in the treaty. See the exhibit "Sample Extra-Contractual Obligations Clause."

Comparison of Excess of Policy Limits and Extra-Contractual Obligations Clauses

	XPL	ECO
Allegations by the Plaintiff	Primary insurer's bad faith, fraud, or gross negligence in handling a third-party claim against the insured	Primary insurer's bad faith, fraud, or gross negligence in handling the insured's claim
Relationship of Damages to Policy Coverage	Would be covered by the policy if the policy limit was higher	Go beyond policy coverage
Type of Coverage Typically Used With	Liability insurance and property insurance with bailee liability loss exposures	Property or liability insurance

[DA05199]

Sample Extra-Contractual Obligations Clause

16 B

EXTRA CONTRACTUAL OBLIGATIONS

This Contract shall protect the Company for any Extra Contractual Obligations within the limits hereof. The term "Extra Contractual Obligations" is defined as those liabilities not covered under any other provision of this Contract and which arise from the handling of any claim on business covered hereunder, such liabilities arising because of, but not limited to, the following: failure by the Company to settle within the policy limit, or by reason of alleged or actual negligence, fraud, or bad faith in rejecting an offer of settlement or in the preparation of the defense or in the trial of any action against its insured or reinsured or in the preparation or prosecution of an appeal consequent upon such action.

The date on which any Extra Contractual Obligation is incurred by the Company shall be deemed, in all circumstances, to be the date of the original disaster and/or casualty.

However, this Article shall not apply where the loss has been incurred due to fraud by a member of the Board of Directors or a corporate officer of the Company acting individually or collectively or in collusion with any individual or corporation or any other organization or party involved in the presentation, defense or settlement of any claim covered hereunder.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/contractword/Extra%20Contractual%20Obligations%20BRMA%2016A-F.doc (accessed November 6, 2012). [DA05200]

Territory Clause

The territory clause defines the geographic area within which loss exposures must be located to be covered by the reinsurance treaty. Through the territory clause, the reinsurer manages the geographic spread of its loss exposures and ensures that the primary insurer is operating in mutually agreed-on areas. For example, if a primary insurer operates in only one state, the territory clause would limit the treaty's applicability to policies sold in that state. Subsequent expansion into other states for this primary insurer would create a reinsurance underwriting issue requiring reinsurer approval before the treaty was modified. See the exhibit "Sample Territory Clause."

Sample Territory Clause

51 B

TERRITORY

This Contract shall apply to risks located in the United States of America, its territories, its possessions, the Commonwealth of Puerto Rico, the District of Columbia, and incidental foreign exposures.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/contractword/Territory%20BRMA%2051A-D.doc (accessed November 6, 2012). [DA05201]

Self-Insured Obligations Clause

The self-insured obligations clause extends the reinsurance treaty to include policies issued by the primary insurer that provide coverage for its own loss exposures. This clause is needed because a primary insurer's insurance contracts with itself are legally unenforceable and would not otherwise create an indemnification obligation for the reinsurer. The self-insured obligations clause enables the primary insurer to reinsure its own loss exposures as though they were for an unaffiliated insured.

Reinsurers are usually willing to add the self-insured obligations clause to maintain goodwill with the primary insurer, but with specific conditions, such as these:

- The reinsurer must be notified, or even approve, of these agreements. However, some self-insured obligation clauses provide for automatic approval without notification.
- The primary insurer must charge itself the same premium that it would charge unaffiliated insureds.
- The primary insurer's payment of a claim to itself creates a legally binding payment for the purposes of the reinsurance treaty even though such action has no true legal status outside the reinsurance treaty.

Additionally, reinsurers often require that primary insurers document their intention to insure their own exposures through either an actual policy or internal memorandum. See the exhibit "Sample Self-Insured Obligations Clause."

Sample Self-Insured Obligations Clause

48 D

SELF-INSURED OBLIGATIONS

As respects all business the subject matter hereof, this Contract shall cover self-insured obligations of the Company assumed by it as a self-insurer including self-insured obligations in excess of any valid and collectible insurance available to the Company to the same extent as if all types of insurance covered by this Contract were afforded under the broadest forms of policies issued by the Company, provided such self-insured obligations are within the scope of underwriting criteria furnished by the Company to the Reinsurer.

For the purpose of this Contract "self-insured obligations" are defined as insurable exposures of the Company on which the Company has issued an actual policy subject to the provisions stipulated in the first paragraph of this Article.

An insurance or reinsurance wherein the Company hereby reinsured and/or its affiliated and/or subsidiary companies are named as the Insured or Reinsured party, either alone or jointly with some other party, shall be deemed to be an insurance or reinsurance coming within the scope of this Contract, notwithstanding that no legal liability may arise in respect thereof by reason of the fact that the Company hereby reinsured and/or its affiliated and/or subsidiary companies are named as the Insured or Reinsured party or one of the Insured or Reinsured parties.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/contractword/Self-Insured%20Obligations%20BRMA%2048A-E.doc (accessed November 6, 2012). [DA05202]

ANCILLARY AGREEMENTS AND ENDORSEMENTS

Reinsurers may use ancillary agreements to provide additional coverages to primary insurers or add endorsements to clarify reinsurance treaty terms.

These are among the most commonly used ancillary agreements and endorsements:

- Special acceptance agreement
- Cut-through endorsement
- Guarantee endorsement
- Indemnity agreement

The sample ancilliary agreements and endorsements are for illustrative purposes only and should not be relied on to construct an actual treaty.

Special Acceptance Agreement

Special acceptance

An ancillary agreement that provides a means to extend the reinsurance treaty to include loss exposures that would otherwise be excluded.

A **special acceptance** agreement is needed in reinsurance treaties that involve several reinsurers and in which securing exceptions to the reinsurance treaty exclusions would be difficult to administer. Special acceptance agreements often specify that the lead reinsurer is authorized to approve special acceptances on behalf of all reinsurers involved in the treaty. See the exhibit "Sample Special Acceptance Clause."

Sample Special Acceptance Clause

Liability of the Company under policies excluded hereunder, may, upon special acceptance by the Lead Reinsurer, be covered by this Agreement and shall be subject to the terms hereof except as such terms shall be modified by such acceptance.

[DA09101]

The exhibit shows an example of a special acceptance letter from a lead reinsurer. See the exhibit "Special Acceptance Letter Example."

Not all reinsurance treaties involving multiple reinsurers include a special acceptance clause. Many reinsurers do not want to rely on the lead reinsurer for special acceptance decisions and prefer that the primary insurer submits special acceptances to all reinsurers for approval.

Cut-Through Endorsement

Cut-through endorsement

An endorsement that provides that, in the event of the insolvency of the primary insurer, the reinsurer directly assumes the obligations of the primary insurer.

A **cut-through endorsement** gives the insured a direct cause of action against the reinsurer for the reinsured amount of a loss if the primary insurer becomes insolvent. Without the endorsement, the insured, who is not a party to the reinsurance treaty, has no right to recover directly from the reinsurer. Normally, the insured needs no such right because the solvent primary insurer fulfills its obligations under the original policy and is indemnified by the reinsurer to the extent specified in the reinsurance treaty. However, the liquidator of an insolvent primary insurer is not able to treat insurance claimants any differently than any other creditor of the primary insurer in satisfying unmet obligations. The cut-through endorsement provides the insured with direct rights against the reinsurer, bypassing the primary insurer's insolvency proceeding.

A cut-through endorsement is usually requested when the primary insurer does not satisfy the financial standards established by the insured's lender. The endorsement can take many forms, depending on the needs of the parties and the applicable state law. Typically, a cut-through endorsement states that reinsurance proceeds will be paid directly to the payee in the event that the primary insurer is unable to pay a loss. The payee may be the insured, the lender, or both. The reinsurer will respond to the insured and lender, as their interests may appear, up to the limit of the reinsurance treaty. A cut-through

Special Acceptance Letter Example

May 18, 20X4

Ms. Audrey Amann
Commercial Lines Department
Crowley Fire and Marine Insurance Companies
123 XYZ Lane
West Chester, Pennsylvania 19382

Re: KENCO Enterprises
Policy Number: 33.140124

Dear Ms. Amann,

This will acknowledge your letter of April 29, 20X4, enclosing a copy of the captioned policy.

For the purposes of this policy only, the reinsurance limit under the reinsurance treaty between our companies applicable to the Employers Liability Stopgap coverage is increased to the extent necessary to complete a policy limit for such coverage of $1,000,000 each occurrence for the policy period from March 1, 20X4, to March 1, 20X5.

This acceptance applies only to the current policy and its present provisions, and any changes or renewal should be brought to our attention for further consideration.

An extra copy of this letter is enclosed for your use as a reminder of the special handling required on this policy.

Sincerely,

Richard Balaban, CPCU, ARe
Senior Vice President

[DA05130]

clause may be added to the reinsurance agreement to allow the primary insurer to issue cut-through endorsements when required.

The insolvent primary insurer's liquidator may contest enforcement of the cut-through endorsement because it reduces available funds that can be directed to other creditors. The insolvency clause reinforces this argument by specifying that reinsurance will be paid to the liquidator "without diminution." In this case, reinsurers may be required to pay a claim twice—once on behalf of the insured under the terms of the cut-through endorsement, and again to the liquidator of the insolvent primary insurer.

Reinsurers may also prefer to avoid cut-through endorsements because of the administrative expenses in tracking them and because of the potential third-party liability. Because the cut-through endorsement is only attached to ~~policies when requested,~~ the primary insurer and reinsurer must keep records of the endorsed policies. In reinsurance treaties involving more than one reinsurer, all of the reinsurers must subscribe to an indemnity agreement with the reinsurer that issues the cut-through endorsement. See the exhibit "Sample Cut-Through Endorsement."

Sample Cut-Through Endorsement

In the event of the temporary or permanent discontinuance of business by the Company, or if the Company be adjudged insolvent, or if the Company shall fail to pay any loss under said policy or policies within the time provided in said policy or policies, then the insured or insureds under said policy or policies shall have the right to bring an action hereon against the Reinsurer in the state of the Reinsurer's domicile to recover that portion of the loss sustained by such insured or insureds, and for which the Company would be liable under the terms and provisions of said policy or policies, that exceeds the primary liability retained by the Company hereunder and that is assumed by the Reinsurer hereunder.

[DA05131]

Guarantee endorsement

An endorsement attached to an insurance policy covering mortgaged property that gives the insured a direct cause of action against the reinsurer for the entire covered amount of a loss if the primary insurer becomes insolvent.

Guarantee Endorsement

A **guarantee endorsement**, also known as a mortgagee endorsement, applies to policies covering mortgaged property and is similar to a cut-through endorsement. Whereas a cut-through endorsement allows an insured to recover the reinsured amount of a loss directly from the reinsurer, a guarantee endorsement allows the insured to recover the entire covered loss from the reinsurer, regardless of how much was reinsured.

A guaranty bond is used in Texas because guarantee endorsements are not approved for use there. A guaranty bond must conform to the Texas Department of Insurance requirements.

Indemnity agreement

An ancillary agreement among co-reinsurers to a reinsurance treaty, that provides that they will pay their proportionate share of the liabilities assumed under a cut-through endorsement or guarantee endorsement to the issuing reinsurer.

Indemnity Agreement

Only one reinsurer is the named guarantor under guarantee and cut-through endorsements. However, several reinsurers frequently participate in one treaty. Under such circumstances, the co-reinsurers execute an **indemnity agreement** (sometimes called a hold-harmless agreement).

The key provisions of an indemnity agreement are that the co-reinsurer is required to pay its proportionate share of the loss and associated loss adjustment expenses (with proportionate share defined as the same share that the co-reinsurer has in the treaty) and that the issuing reinsurer is not required to issue assumption of liability agreements and can cancel any outstanding agreements at any time. The latter provision ensures that the co-reinsurers clearly understand the issuing reinsurer's rights and obligations. See the exhibit "Sample Indemnity Agreement."

▶▶

Sample Indemnity Agreement

(Assumption of Liability Agreements—Other Participating Reinsurers)

Participating Reinsurer

Policy Issuing Company

This Agreement between Excellent Reinsurance Company, 123 William Street, New York, New York 10038 (hereinafter referred to as the "Indemnitee") and the Participating Reinsurer designated above (hereinafter referred to as the "Indemnitor") is entered into for the benefit of the Indemnitee for the reasons stated in the following recitals:

SECTION ONE—RECITALS

(a) The Policy Issuing Company designated above has requested the Indemnitee issue Reinsurance Endorsements, Indemnification Agreements and Guarantee Endorsements (hereinafter referred to as "Assumption of Liability Agreements") for the benefit of the mortgagees under which the Indemnitee may, in the event of the insolvency of the Policy Issuing Company, become directly obligated to the mortgagees for the payment of certain losses to real property under the insurance policies issued to said mortgagees; and

(b) The Indemnitor has a reinsurance agreement with the Policy Issuing Company covering a proportion of the risk of loss under said policies; and

(c) The Indemnitee, as a condition precedent to the issuance of Assumption of Liability Agreements, requires other participating reinsurers to assume a proportion of risk under said Assumption of Liability Agreements.

SECTION TWO—INDEMNIFICATION

In consideration of the Indemnitee issuing said Assumption of Liability Agreements, the Indemnitor agrees that in the event the Indemnitee is required to pay any loss directly to any Mortgagee, the Indemnitor shall pay the Indemnitee:

(a) The same proportionate share of the loss paid by the Indemnitee as the Indemnitor has in the above referenced reinsurance agreement; and

(b) The same proportionate share of any necessary expenses, attorney's fees or costs incurred in the performance of such Assumption of Liability Agreements.

SECTION THREE—OBLIGATION OF INDEMNITEE

This Agreement shall not in any way be construed to require the Indemnitee to issue Assumption of Liability Agreements, or to deprive the Indemnitee of any right to cancel such Agreements at any time it might desire.

SECTION FOUR—BINDING EFFECT OF AGREEMENT

This Agreement shall be binding upon and inure to the benefit of the parties, their successors and assigns.

IN WITNESS whereof, the parties hereto have executed this Agreement on this the ________ day of ______________, 20______.

Company: Excellent Reins. Co.

By: ____________________________ By: ____________________________

[DA05132]

SUMMARY

Reinsurance treaties often include common clauses that vary by type of reinsurance or provide specialized coverage. Common treaty clauses that vary by type of reinsurance include commencement and termination clauses and reports and remittances clauses. Common treaty clauses that provide specialized coverage include XPL clauses, ECO clauses, territory clauses, and self-insured obligations clauses.

Commonly used ancillary agreements and endorsements include special acceptance agreements, cut-through endorsements, guarantee endorsements, and indemnity agreements. A special acceptance agreement provides a means to extend the reinsurance treaty to include loss exposures that would otherwise be excluded. A cut-through endorsement gives the insured a direct cause of action against the reinsurer for the reinsured amount of a loss if the primary insurer becomes insolvent. A guarantee endorsement is attached to an insurance policy covering a mortgaged property and gives the insured a direct cause of action against the reinsurer for the entire covered amount of a loss if the primary insurer becomes insolvent. An indemnity agreement is an agreement among co-reinsurers that provides that they will pay their proportionate share of the liabilities assumed under a cut-through endorsement or guarantee endorsement to the issuing reinsurer.