Direct Your Learning

4

Common Reinsurance Treaty Clauses, Part I

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:
  - Preamble
  - Affiliated companies clause
  - Reinsuring clause
  - Definitions clause
  - Access to records clause
  - Federal excise tax clause
  - Currency clause
  - Governing law clause
  - Exclusion clauses
  - Arbitration clause
  - Offset clause
  - Errors and omissions clause
- Describe the purpose of each of the following reinsurance treaty clauses that may be required under state regulations for primary insurers to qualify for financial statement credit for reinsurance:
  - Service of suit clause
  - Insolvency clause
  - Intermediary clause
  - Unauthorized reinsurance clause
  - Funding clause
- Describe the purpose of the interests and liabilities agreement that may be attached to a reinsurance treaty.

Outline

Common Reinsurance Treaty Clauses, Part I

4

CLAUSES COMMON TO MOST REINSURANCE TREATIES

Reinsurance agreements are usually broad in scope and contain wording to cover many different situations. Each reinsurance agreement's wording is unique because it states the intent of the parties to that particular agreement. However, some clauses are common to most reinsurance agreements.

Reinsurers have developed common clauses that are contained in most reinsurance treaties and are necessary for the treaty to function. Because the wording contained in common clauses varies, understanding these clauses is essential to understanding the rights and duties of the parties to the reinsurance agreement.

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

Preamble

The preamble is the introduction to a reinsurance treaty that identifies the parties to the treaty. The primary insurer is usually designated as the "Company" or the "Reinsured." See the exhibit "Sample Preamble."

Affiliated Companies Clause

The **affiliated companies clause** states that the primary insurer specified in the preamble includes the primary insurer's affiliated companies. The purpose of the affiliated companies clause is to broaden the reinsurer's liability by including losses suffered by the primary insurer's affiliated companies.

Some versions of the affiliated companies clause require that the reinsurer receive notification of the addition of newly affiliated companies. If notification is required, and if the reinsurer is not willing to extend the agreement to the newly affiliated company, the primary insurer is usually given a specified period, such as forty-five days, to make other reinsurance arrangements for that affiliate.

Affiliated companies clause
A reinsurance treaty clause that broadens the treaty's scope to include the primary insurer's affiliated companies.

Sample Preamble

PROPERTY QUOTA SHARE
REINSURANCE AGREEMENT

NUMBER 01234

entered into by and between

HILL COUNTRY FIRE AND MARINE INSURANCE COMPANY

Des Moines, Iowa

(hereinafter referred to as the "Company")

and

Delmar Reinsurance Company

Wilmington, Del.

(hereinafter referred to as the "Reinsurer")

[DA05105]

The exhibit shows an affiliated companies clause that requires notice to and approval of the reinsurer when adding an affiliated company. This example names the "first named affiliated company" as the agent for communication between the "Company" and the "Reinsurer." See the exhibit "Sample Affiliated Companies Clause."

Reinsuring Clause

The reinsuring clause (sometimes called the business reinsured clause or business covered clause) establishes the obligatory nature of the cessions under the treaty and describes the type of reinsurance provided. It may also contain these provisions:

- Definition of policies
- Insurance policies covered
- Basis of attachment for policies

Definition of Policies

A standard reinsuring clause defines policies as "policies, contracts, and binders of insurance." The reinsuring clause may have a provision specifying that policies sold on an installment premium basis, a reporting form basis, or a continuous basis are to be considered renewed as of the end of the annual period beginning with the policy's inception date.

Sometimes the definition provision includes reinsurance assumed by the primary insurer, which means that the treaty is also a retrocession. The reinsuring clause in the exhibit includes reinsurance in the definition of policies. See the exhibit "Sample Reinsuring Clause."

Sample Affiliated Companies Clause

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AFFILIATED COMPANIES

Whenever the word "Company" is used in this Contract, such term shall be held to include any or all of the affiliated companies which are or may hereafter be under common control, provided that notice be given to the Reinsurer of any such newly affiliated companies which may hereafter come under common control as soon as practicable with full particulars as to how such affiliation is likely to affect this Contract. In the event of either party maintaining that such affiliation calls for alteration in existing terms, and an agreement for alteration not being arrived at, then the business of such newly affiliated company is covered at existing terms only for a period of forty-five (45) days after notice by either party that it does not wish to cover such business.

The first named affiliated company hereunder shall be deemed to be the agent of the Company.

The retention of the Company and the liability of the Reinsurer and all other benefits accruing to the Company as provided in this Contract or any amendments hereto, shall apply to the affiliated companies comprising the Company as a group and not separately to each of the affiliated companies.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/contractword/Affiliated%20Companies%20BRMA%202A-F.doc (accessed November 8, 2012). [DA09212]

Sample Reinsuring Clause

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REINSURING CLAUSE

By this Contract the Company obligates itself to cede to the Reinsurer and the Reinsurer obligates itself to accept _____% quota share reinsurance of the Company's gross liability under policies, contracts and binders of insurance or reinsurance (hereinafter called "policies") in force at and becoming effective at and after (hour) (date) (year), including renewals, and classified by the Company as _____.

The liability of the Reinsurer with respect to each cession hereunder shall commence obligatorily and simultaneously with that of the Company, subject to the terms, conditions and limitations hereinafter set forth.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/frommemcontractwd01.htm (accessed November 8, 2012). [DA09214]

Insurance Policies Covered

The provision that describes the insurance policies covered by a reinsuring clause can be specific or general. For example, the reinsuring clause may name a particular type of insurance or may describe the loss exposures covered as all policies underwritten by a particular department of the primary insurer. These are examples of how insurance policies can be identified in a reinsuring clause:

- Homeowners
- Commercial property and multiperil, inland marine, and dwelling fire business
- Property business
- Insurance policies underwritten by the primary insurer's commercial casualty department
- Insurance policies sold by a specific company, at a certain location, for and on behalf of the company—for example, Washington General Agency, Seattle, Washington

Generally, the broader the reinsuring clause, the more exclusions are necessary to indicate precisely what is covered. For example, the reinsuring clause may indicate that the treaty covers all policies originating from the property department of the primary insurer. However, the reinsurer may intend to exclude a specific type of property insurance, such as equipment breakdown.

Basis of Attachment for Policies

This provision of a reinsuring clause identifies which of the primary insurer's policies, according to their effective dates, are covered by the treaty. The two common bases of reinsurance treaty attachment are **risks attaching basis** and **losses occurring basis**.

Risks attaching basis

A reinsurance attachment basis that covers policies issued or renewed by the primary insurer on or after the reinsurance treaty's effective date.

Losses occurring basis

A reinsurance attachment basis that covers the unearned portion of policies in force as well as policies issued or renewed by the primary insurer on or after the reinsurance treaty's effective date.

When a reinsurer accepts liability on a risks attaching basis, it becomes responsible only for losses under policies issued or renewed on or after the treaty's effective date. Primary insurers should realize that claims may be presented after the treaty's inception date for losses that occurred before the inception date. Such losses would not be covered by the new treaty. The previous treaty may cover these losses (run-off), but if it does not, a coverage gap would exist in the primary insurer's reinsurance program. As an alternative, the risks attaching basis can be modified to include in-force, new, and renewed policies, with reinsurers collecting appropriate premiums for the added loss exposures. Another alternative is to use a losses occurring basis.

When a reinsurer assumes liability on a losses occurring basis, it becomes responsible for all losses occurring on or after the reinsurance treaty's inception date, regardless of when the underlying policy was issued. The losses occurring basis may be used if the primary insurer has an expiring reinsurance treaty on a cut-off basis to prevent a gap in reinsurance coverage. The reinsuring clause in the "Sample Reinsuring Clause" exhibit illustrates an obligatory cession and assumption on a losses occurring basis.

Two other bases of reinsurance treaty attachment are more limited in scope and are, consequently, used less frequently: **policies issued basis** and **in-force policies basis**.

Policies issued basis

A reinsurance attachment basis that covers only new policies issued on or after the reinsurance treaty's effective date.

In-force policies basis

A reinsurance attachment basis that covers only the unearned portion of in-force policies.

Reinsurers may want to use the policies issued basis when the primary insurer has significantly changed its underwriting guidelines to correct unfavorable loss experiences. In such instances, the treaty would cover newly issued policies, but the existing policies with poor loss experience would not be covered.

Primary insurers may want to use the in-force policies basis to run off existing policies. Because no new policies are being sold, the in-force policies basis would provide all the coverage needed.

Primary insurers' accounting systems may dictate which attachment basis can be used. For example, if a primary insurer's accounting system is not capable of separating earned and unearned premium on a risks attaching basis, the primary insurer would need to use another basis, such as the losses occurring basis.

Definitions Clause

The definitions clause defines the terms used in the treaty. The purpose of a separate definitions clause is to make locating the definitions easy. However, some reinsurers prefer to define a term when it first appears in the treaty. For example, risk may be defined in the reinsuring clause, and net loss may be defined in the treaty's losses section. Ultimately, it is a matter of preference.

Even if a definitions clause is used, some terms may be defined as they are used in other clauses. For example, net profit may be defined in an exclusions clause, rather than in the definitions clause. See the exhibit "Sample Definitions Clause."

Sample Definitions Clause

A. The term "Policy" as used in this Agreement shall mean any binder, policy, or contract of insurance or reinsurance issued, accepted, or held covered provisionally or otherwise, by or on behalf of the Company.

B. The term "Casualty Business" as used in this Agreement shall mean all insurances and reinsurances written by the Company and classified by the Company as Casualty.

[DA05108]

Access to Records Clause

The access to records clause gives the reinsurer the contractual right to inspect all of the primary insurer's records that pertain to the coverage provided by the reinsurance treaty. This right is essential for conducting underwriting, claim, and transactional audits of the primary insurer. It is also important to the reinsurer because it protects the reinsurer against attempts by the primary insurer to withhold information in a dispute. See the exhibit "Sample Access to Records Clause."

Sample Access to Records Clause

1 B

ACCESS TO RECORDS

The Reinsurer or its designated representatives shall have free access to the books and records of the Company on matters relating to this reinsurance at all reasonable times for the purpose of obtaining information concerning this Contract or the subject matter hereof.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/frommemcontractwd01.htm (accessed November 8, 2012). [DA09215]

The provisions of the access to records clause answer these questions:

- Who must be given access to the records?—The "Sample Access to Records Clause" exhibit specifies that the "Reinsurer or its designated representatives" are to be provided access. At one time, the access to records clause specified that only the reinsurer had access, which was interpreted to include employees of the reinsurer but not third parties hired by the reinsurer to inspect the primary insurer's records on its behalf.
- What is the scope of the investigation of records?—The reinsurer's right of access is limited to records that relate to the reinsurance provided by the treaty. For example, a reinsurer cannot assert a right to access records on a type of insurance that the treaty does not cover.
- What material must be made available for review?—Generally, all of the primary insurer's records that pertain in any way to the treaty must be made available. For these purposes, records include accounting, underwriting, and claim information on any media, including computer records. The types of documents or records are usually not listed because doing so could limit the primary insurer's disclosure obligation to only those documents or records specifically named.
- Where must the records be made available for review?—Although the clause may not specify the location, generally the reinsurer must go to where the records are normally located. An exception is when the

records are in long-term storage. Under such circumstances, the reinsurer can expect the primary insurer to bring the records out of storage and make them available for review at the business office responsible for maintaining them.

- When must access be made available?—The "Sample Access to Records Clause" exhibit specifies "all reasonable times," a phrase that is undefined but that generally means during the primary insurer's normal business hours.
- Is there a time limit to access?—The reinsurer usually has the right to access the primary insurer's records even after the treaty has been terminated. For example, environmental claims often involve the research of old policies and treaties.

Federal Excise Tax Clause

The United States federal excise tax clause states that the primary insurer is responsible for administering and remitting the federal excise tax levied against alien reinsurers (a reinsurer that is incorporated under the laws of any other country than the U.S.) party to the reinsurance treaty. Reinsurance premiums are usually taxed at a rate of 1 percent on the gross amount ceded without reduction for ceding commissions received on reinsurance ceded.

The federal excise tax is owed when the reinsurance premium payment is made to an alien reinsurer. The primary insurer becomes liable for the federal excise tax when payments are made to a nonresident agent, solicitor, or reinsurance intermediary, or when funds are transferred to any bank, trust fund, or similar recipient designated by the alien insurer.The federal excise tax clause also states that the primary insurer is responsible for recovering any overpayment of federal excise tax on the reinsurer's behalf.

Transactions with alien reinsurers may be exempt from the U.S. federal excise tax. Alien reinsurers whose premiums are subject to U.S. income tax are generally exempt from federal excise tax. A few countries have trade agreements with the U.S. that exempt reinsurers in both countries from paying federal excise taxes. The most notable examples are Germany, Great Britain, and Bermuda. If the reinsurer is exempt from federal excise tax, there is no need to include a federal excise tax clause in the reinsurance agreement. See the exhibit "Sample Federal Excise Tax Clause."

Currency Clause

The currency clause specifies the base currency for the treaty and the basis of any conversion to the base currency. Frequently, the currency clause requires reporting in original currencies (ones that appear on the underlying policies) and converting those currencies at the prevailing exchange rates on the date that balances are entered on the primary insurer's books.

Sample Federal Excise Tax Clause

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FEDERAL EXCISE TAX

(Applicable to those reinsurers, excepting Underwriters at Lloyd's London and other reinsurers exempt from Federal Excise Tax, who are domiciled outside the United States of America.)

A. The reinsurer has agreed to allow for the purpose of paying the Federal Excise Tax (one percent) of the premium payable hereon to the extent such premium is subject to the Federal Excise Tax.

B. In the event of any return of premium becoming due hereunder the Reinsurer will deduct the aforesaid percentage from the return premium payable hereon and the Company or its agent should take steps to recover the tax from the United States Government.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/frommemcontractwd01.htm (accessed November 8, 2012). [DA09217]

The currency clause shown in the exhibit specifies U.S. dollars as the base currency. See the exhibit "Sample Currency Clause."

Sample Currency Clause

12 A

CURRENCY

Whenever the word "Dollars" or the "$" sign appears in this Contract, they shall be construed to mean United States Dollars and all transactions under this Contract shall be in United States Dollars.

Amounts paid or received by the Company in any other currency shall be converted to United States Dollars at the rate of exchange at the date such transaction is entered on the books of the Company.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/frommemcontractwd01.htm (accessed November 8, 2012). [DA09218]

Governing Law Clause

The governing law clause specifies which law governs the reinsurance treaty. Without such a clause, the law of any alien reinsurer's domicile would likely prevail in the event of a dispute with the alien reinsurer. See the exhibit "Sample Governing Law Clause."

Sample Governing Law Clause

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GOVERNING LAW

This Contract shall be governed as to performance, administration and interpretation by the laws of the State of _____, exclusive of the rules with respect to conflicts of law, except as to rules with respect to credit for reinsurance in which case the applicable rules of all states shall apply.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/frommemcontractwd01.htm (accessed November 8, 2012). [DA09219]

Exclusion Clauses

Virtually all reinsurance treaties contain exclusions that limit the treaty's coverage. Each treaty reflects the specific intentions of the parties, so no standard list of exclusions exists. Also, no standard exclusion wordings exist, although the Lloyd's Market Association (LMA) has developed some exclusion wordings that are widely used.

Some exclusions are specific to a particular type of reinsurance. For example, a casualty treaty may specifically exclude burglary and theft coverage. In some cases, reinsurers depend on exclusions contained in the primary insurers' policies rather than on reinsurance treaty exclusions.

Exclusion clauses usually apply to high-hazard loss exposures and causes of loss that are not customarily covered by reinsurance treaties. Examples of high-hazard loss exposures include loss exposures covered by equipment breakdown policies or by policies for businesses that transport and dispose of radioactive waste. These are examples of causes of loss that are not customarily covered by reinsurance treaties:

- Nuclear incident
- Pollution and seepage
- War risk
- Terrorism
- Insolvency fund assessments

Nuclear Incident Exclusion Clause

Most worldwide primary insurers and reinsurers participate in nuclear reinsurance pools. As a result, reinsurers avoid accumulating additional nuclear loss exposures through treaties with primary insurers. Therefore, a nuclear incident exclusion clause in a treaty excludes nuclear loss exposures, except for specific incidental loss exposures. Examples of these exceptions include nuclear hazards common to the radiological services of hospitals.

Nuclear incident exclusion clauses vary by type of insurance and by territory. The exhibit shows an excerpt from a nuclear incident exclusion clause that could be attached to a U.S. property treaty covering equipment breakdown loss exposures located in the U.S. The clause in the exhibit applies to "any loss or liability" resulting from the primary insurer's participation in a nuclear reinsurance pool. It also excludes the primary insurer's losses or liability (as an insurer or reinsurer) from the types of loss exposures that a nuclear reinsurance pool normally insures. See the exhibit "Sample Nuclear Incident Exclusion Clause (Excerpt)."

Sample Nuclear Incident Exclusion Clause (Excerpt)

35 E

NUCLEAR INCIDENT EXCLUSION CLAUSE PHYSICAL DAMAGE AND LIABILITY (BOILER AND MACHINERY POLICIES)* – REINSURANCE – U.S.A.

(1) This reinsurance does not cover any loss or liability accruing to the Reassured as a member of, or subscriber to, any association of insurers or reinsurers formed for the purpose of covering nuclear energy risks or as a direct or indirect reinsurer of any such member, subscriber or association.

(2) Without in any way restricting the operation of paragraph (1) of this Clause, it is understood and agreed that for all purposes of this reinsurance all original Boiler and Machinery Insurance or Reinsurance contracts of the Reassured shall be deemed to include the following provisions of this paragraph:

This Policy does not apply to "loss," whether it be direct or indirect, proximate or remote

(a) from an Accident caused directly or indirectly by nuclear reaction, nuclear radiation or radioactive contamination, all whether controlled or uncontrolled; or

(b) from nuclear reaction, nuclear radiation or radioactive contamination, all whether controlled or uncontrolled, caused directly or indirectly by, contributed to or aggravated by an Accident.

(3) However, it is agreed that loss arising out of the use of Radioactive Isotopes in any form is not hereby excluded from reinsurance protection.

**Note: "Boiler and Machinery" policies are commonly referred to as "Equipment Breakdown" policies.*

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/frommemcontractwd01.htm (accessed November 8, 2012). [DA09220]

Pollution Exclusion Clause

A pollution exclusion clause excludes loss or damage resulting from pollution. A variety of pollution exclusion clauses are currently in use, including a seepage and pollution exclusion clause, which excludes loss or damage resulting

from seepage, pollution, and contamination. Usually, the pollution exclusion clause is tailored to the type of loss exposure—property or liability—underlying the reinsurance treaty. Reinsurers typically do not want to provide pollution coverage in treaties except under narrowly defined circumstances.

In some cases, a reinsurer will ask a primary insurer to warrant that it will use the standard Insurance Services Office, Inc. (ISO) pollution exclusion clause in its underlying general liability policies. The exhibit shows a broad pollution exclusion clause relating to loss exposures insured through underlying general liability policies. See the exhibit "Sample Pollution Exclusion Clause."

War Risk Exclusion Clause

The war risk exclusion clause excludes loss or damage resulting from organized war or warlike activities. The clause typically contains these two notable provisions:

- The exclusion does not apply to loss exposures located in the U.S. if the primary insurer's policy includes a standard war risk exclusion clause.
- The exclusion does not apply to losses from general riots, strikes, and civil commotion.

The clause has a limited effect on reinsurance for the majority of U.S. primary insurers because their policies already exclude war risks in most cases. See the exhibit "Sample War Risk Exclusion Clause."

Terrorism Exclusion Endorsement

A terrorism exclusion endorsement excludes loss or damage resulting from acts of terrorism. Many reinsurers began adding terrorism exclusions to reinsurance treaties after the terrorist attacks of September 11, 2001. Primary insurers and reinsurers were obligated to cover most of the losses resulting from the attacks, which were unprecedented in terms of the loss of life, personal injury, and property damage.

Because of the unpredictability and potential extent of future terrorism losses, most reinsurers determined terrorism to be an uninsurable cause of loss. Primary insurers are required to provide terrorism coverage in certain lines of insurance. Reinsurance is provided by the federal government under the Terrorism Risk Insurance Act (TRIA). See the exhibit "Sample Terrorism Exclusion Endorsement."

Often reinsurers combine the war risk exclusion and the terrorism exclusion into one endorsement called the War and Terrorism Exclusion Endorsement. See the exhibit "Sample War and Terrorism Exclusion Endorsement."

Insolvency Fund Exclusion Clause

Virtually all reinsurance treaties contain an insolvency fund exclusion clause stating that reinsurers will not indemnify primary insurers for any assessments

Sample Pollution Exclusion Clause

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POLLUTION EXCLUSION CLAUSE - GENERAL LIABILITY - REINSURANCE

A. This reinsurance excludes all loss and/or liability accruing to the reinsured company as a result of:

1. bodily injury or property damage arising out of the actual, alleged or threatened discharge, dispersal, release or escape of pollutants:
   a. at or from premises owned, rented or occupied by a named insured;
   b. at or from any site or location used by or for a named insured or others for the handling, storage, disposal, processing or treatment of waste;
   c. which are at any time transported, handled, stored, treated, disposed of, or processed as waste by or for a named insured or any person or organization for whom a named insured may be legally responsible; or
   d. at or from any site or location on which a named insured or any contractors or subcontractors working directly or indirectly on behalf of a named insured are performing operations:
      (i) if the pollutants are brought on or to the site or location in connection with such operations; or
      (ii) if the operations are to test for, monitor, clean up, remove, contain, treat, detoxify or neutralize the pollutants;
2. any governmental direction or request that a named insured test for, monitor, clean up, remove, contain, treat, detoxify or neutralize pollutants.

B. Subparagraphs A(1)(a) and A(1)(d)(i) above do not apply to bodily injury or property damage caused by heat, smoke or fumes from a hostile fire.

C. "Hostile fire" means a fire which becomes uncontrollable or breaks out from where it was intended to be.

D. "Pollutants" means any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals and waste. Waste includes material to be recycled, reconditioned or reclaimed.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/frommemcontractwd01.htm (accessed November 8, 2012). [DA09222]

State guaranty funds
Nonprofit, unincorporated associations established in all states to pay the outstanding claims of insolvent primary insurers.

that the primary insurers must pay to **state guaranty funds** because of another primary insurer's insolvency. All insurers selling types of insurance covered by the guaranty fund are automatically association members. The insolvency fund exclusion clause in the exhibit includes a broad definition of "insolvency fund" to provide maximum protection for the reinsurer. See the exhibit "Sample Insolvency Fund Exclusion Clause."

Sample War Risk Exclusion Clause

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WAR RISK EXCLUSION CLAUSE (REINSURANCE)

As regards interests which at time of loss or damage are on shore, no liability shall attach hereto in respect of any loss or damage which is occasioned by war, invasion, hostilities, acts of foreign enemies, civil war, rebellion, insurrection, military or usurped power, or martial law or confiscation by order of any government or public authority.

This War Exclusion Clause shall not, however, apply to interests which at time of loss or damage are within the territorial limits of the United States of America (comprising the fifty States of the Union and the District of Columbia, its territories and possessions, including the Panama Canal Zone and the Commonwealth of Puerto Rico and including Bridges between the United States of America and Mexico, provided they are under United States ownership), Canada, St. Pierre and Miquelon, provided such interests are insured under original policies, endorsements or binders containing a standard war or hostilities or warlike operations exclusion clause.

Nevertheless, this clause shall not be construed to apply to loss or damage occasioned by riots, strikes, civil commotion, vandalism, malicious damage, including acts committed by agents of any government, party or faction engaged in war, hostilities or other warlike operation, provided such agents are acting secretly and not in connection with any operations of military or naval armed forces in the country where the interests insured are situated.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/frommemcontractwd01.htm (accessed November 8, 2012). [DA09223]

Arbitration Clause

The arbitration clause states that an arbitration process will be used to resolve disputes between the parties to the treaty. Arbitration is typically conducted by a panel of disinterested third parties who are familiar with insurance and reinsurance business practices. The exhibit shows one example of an arbitration clause, but many versions of arbitration clauses are in use. See the exhibit "Sample Arbitration Clause."

Arbitration Required

The parties must use an arbitration panel as described in the arbitration clause if they are unable to settle a dispute. In the "Sample Arbitration Clause" exhibit, the stipulation "As a condition precedent to any right of action hereunder..." means that before either party can take legal action, the dispute must be arbitrated. Insurers have made many unsuccessful attempts to

Sample Terrorism Exclusion Endorsement

56 F

TERRORISM EXCLUSION ENDORSEMENT (Reinsurance)

Notwithstanding any provision to the contrary within this reinsurance or any endorsement thereto, it is agreed that this reinsurance excludes loss, damage, cost or expense of whatsoever nature directly or indirectly caused by, resulting from or in connection with any act of terrorism, regardless of any other cause or event contributing concurrently or in any other sequence to the loss.

For the purpose of this endorsement, an act of terrorism means an act, including but not limited to the use of force or violence and/or the threat thereof, of any person or group(s) of persons, whether acting alone or on behalf of or in connection with any organisation(s) or government(s), committed for political, religious, ideological or similar purposes including the intention to influence any government and/or to put the public, or any section of the public, in fear.

This endorsement also excludes loss, damage, cost or expense of whatsoever nature directly or indirectly caused by, resulting from or in connection with any action taken in controlling, preventing, suppressing or in any way relating to any act of terrorism.

If the Reinsurers allege that by reason of this exclusion, any loss, damage, cost or expense is not covered by this reinsurance, the burden of proving the contrary shall be upon the Reassured.

In the event any portion of this endorsement is found to be invalid or unenforceable, the remainder shall remain in full force and effect.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/frommemcontractwd01.htm (accessed November 8, 2012). [DA09225]

circumvent the provisions of an arbitration clause. For example, insurers have claimed these and similar arguments, none of which has been successful:

- The treaty has expired.
- The clause applies to disputes arising out of transactions under the treaty, not to disputes over the treaty wording itself.
- The clause does not apply to denials of coverage under the treaty.
- The clause handles disputes over business practice, not fraud.

Time Limits

A goal of arbitration is to resolve the dispute quickly. Consequently, the arbitration clause specifies that arbitrators must be appointed within a specified time limit, usually thirty days. The parties then have a prescribed time within which to present their cases to the arbitration panel. This panel has the authority to approve time extensions to allow all material and witnesses' statements to be presented.

Sample War and Terrorism Exclusion Endorsement

56 E

WAR AND TERRORISM EXCLUSION ENDORSEMENT (Reinsurance)

Notwithstanding any provision to the contrary within this reinsurance or any endorsement thereto, it is agreed that this reinsurance excludes loss, damage, cost or expense of whatsoever nature directly or indirectly caused by, resulting from or in connection with any of the following, regardless of any other cause or event contributing concurrently or in any other sequence to the loss;

(1) war, invasion, acts of foreign enemies, hostilities or warlike operations (whether war be declared or not), civil war, rebellion, revolution, insurrection, civil commotion assuming the proportions of or amounting to an uprising, military or usurped power; or

(2) any act of terrorism.

For the purpose of this endorsement, an act of terrorism means an act, including but not limited to the use of force or violence and/or the threat thereof, of any person or group(s) of persons, whether acting alone or on behalf of or in connection with any organisation(s) or government(s), committed for political, religious, ideological or similar purposes including the intention to influence any government and/or to put the public, or any section of the public, in fear.

This endorsement also excludes loss, damage, cost or expense of whatsoever nature directly or indirectly caused by, resulting from or in connection with any action taken in controlling, preventing, suppressing or in any way relating to (1) and/or (2) above.

If the Reinsurers allege that by reason of this exclusion, any loss, damage, cost or expense is not covered by this reinsurance, the burden of proving the contrary shall be upon the Reassured.

In the event any portion of this endorsement is found to be invalid or unenforceable, the remainder shall remain in full force and effect.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/contractword/War%20and%20Terrorism%20Risk%20Exclusion%20BRMA%2056A-F.doc (accessed November 13, 2012). [DA09227]

Arbitrators' Qualifications

The arbitrators must be active or retired executives of insurers or reinsurers. In the "Sample Arbitration Clause" exhibit, the term "executive" is undefined and, in practice, is interpreted to mean a senior officer, a vice president, or someone with a high rank. These are key reasons why arbitrators must be executives:

- Usually, a person has not actively participated in reinsurance treaty negotiations and practices until reaching a senior officer level.
- An executive has a broad enough background in insurance practices to consider both sides of a dispute.

Sample Insolvency Fund Exclusion Clause

20 A

INSOLVENCY FUND EXCLUSION

It is agreed that this Contract excludes all liability of the Company arising by contract, operation of law, or otherwise, from its participation or membership, whether voluntary or involuntary, in any insolvency fund. "Insolvency Fund" includes any guaranty fund, insolvency fund, plan, pool, association, fund or other arrangement, howsoever denominated, established or governed, which provides for any assessment of or payment or assumption by the Company of part or all of any claim, debt, charge, fee, or other obligation of an insurer, or its successors or assigns, which has been declared by any competent authority to be insolvent, or which is otherwise deemed unable to meet any claim, debt, charge, fee or other obligation in whole or in part.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/frommemcontractwd01.htm (accessed November 8, 2012). [DA09228]

Additionally, the arbitrators must be disinterested in the arbitration proceedings. Arbitrators usually indicate any involvement they had or have with either of the parties to the arbitration, particularly if they served as appointed arbitrators in a previous arbitration. This minimizes concerns about future legal challenges related to conflicts of interest.

Rules of Procedure and Evidence

In the "Sample Arbitration Clause" exhibit, the arbitrators are "relieved of all judicial formality and shall not be bound by the strict rules of procedure and evidence." This is a shortened reference to older terminology stating that the panel should make its decision based on insurance and reinsurance custom and usage.

The instruction reflects that arbitrators are not jurists but laypersons who are specialists in the subject giving rise to the dispute. Arbitrators should use their best judgment to determine the agreement's original intent and rule accordingly. It is not desirable for the arbitration decision to be contrary to the parties' intent because of a legal technicality.

The Decision

The "Sample Arbitration Clause" exhibit provides that the decision of any two arbitrators is binding on both parties and that any court having jurisdiction can enter the judgment. The arbitration panel does not have the power to enforce its decision. Therefore, if one party does not comply with the decision, the other party must seek enforcement through the civil justice system.

Sample Arbitration Clause

6 L

ARBITRATION

As a condition precedent to any right of action hereunder, any dispute arising out of the interpretation, performance or breach of this Contract, including the formation or validity thereof, shall be submitted for decision to a panel of three arbitrators. Notice requesting arbitration will be in writing and sent certified or registered mail, return receipt requested.

One arbitrator shall be chosen by each party, and the two arbitrators shall, before instituting the hearing, choose an impartial third arbitrator who shall preside at the hearing. If either party fails to appoint its arbitrator within _____ days after being requested to do so by the other party, the latter, after _____ days notice by certified or registered mail of its intention to do so, may appoint the second arbitrator.

If the two arbitrators are unable to agree upon the third arbitrator within _____ days of their appointment, the third arbitrator shall be selected from a list of six individuals (three named by each arbitrator) by a judge of the federal district court having jurisdiction over the geographical area in which the arbitration is to take place, or if the federal court declines to act, the state court having general jurisdiction in such area.

All arbitrators shall be disinterested active or former executive officers of insurance or reinsurance companies or Underwriters at Lloyd's, London.

Within _____ days after notice of appointment of all arbitrators, the panel shall meet and determine timely periods for briefs, discovery procedures and schedules for hearings.

The panel shall be relieved of all judicial formality and shall not be bound by the strict rules of procedure and evidence. Unless the panel agrees otherwise, arbitration shall take place in (City, State), but the venue may be changed when deemed by the panel to be in the best interest of the arbitration proceeding. Insofar as the arbitration panel looks to substantive law, it shall consider the law of the State of _____. The decision of any two arbitrators when rendered in writing shall be final and binding. The panel is empowered to grant interim relief as it may deem appropriate.

The panel shall interpret this Contract as an honorable engagement rather than as merely a legal obligation and shall make its decision considering the custom and practice of the applicable insurance and reinsurance business as promptly as possible following the termination of the hearings. Judgment upon the award may be entered in any court having jurisdiction thereof.

Each party shall bear the expense of its own arbitrator and shall jointly and equally bear with the other party the cost of the third arbitrator. The remaining costs of the arbitration shall be allocated by the panel. The panel may, at its discretion, award such further costs and expenses as it considers appropriate, including but not limited to attorneys fees, to the extent permitted by law.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/frommemcontractwd01.htm (accessed November 8, 2012). [DA09229]

Offset Clause

The offset clause allows the primary insurer and the reinsurer to offset balances due to each other. For example, if the primary insurer owes $125,000 in reinsurance premium and the reinsurer owes the primary insurer $75,000 for a claim, then the primary insurer can send the net balance of $50,000 to the reinsurer. Likewise, if a reinsurer owes more in claims than the primary insurer owes in premium, the reinsurer can send the net claim balance to the primary insurer.

Offsets can apply to premium and losses between the same parties within a single treaty (narrow offset) or across multiple treaties (broad offset). For example, a broad offset would allow the primary insurer and reinsurer to consider all balances due to one another from all their reinsurance treaties together in determining the net amount owed. The clause shown in the exhibit allows broad offset. See the exhibit "Sample Offset Clause."

Sample Offset Clause

36 B

OFFSET

The Company and the Reinsurer may offset any balance or amount due from one party to the other under this Contract or any other contract heretofore or hereafter entered into between the Company and the Reinsurer, whether acting as assuming reinsurer or ceding company. However, in the event of the insolvency of any party hereto, offset shall only be allowed in accordance with applicable law.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/frommemcontractwd01.htm (accessed November 8, 2012). [DA09230]

Errors and Omissions Clause

The errors and omissions (E&O) clause states that neither party is relieved from its obligations under the treaty because of an inadvertent error or omission. Mistakes, such as failing to cede loss exposures that should have been ceded or ceding loss exposures that do not fall within the reinsurance treaty's scope, are not a basis to void the treaty as long as these mistakes are corrected when discovered.

Because of the volume of transactions that are typical of most reinsurance treaties, clerical errors are likely to occur. The E&O clause prevents these clerical errors from affecting the operation of the treaty. See the exhibit "Sample Errors and Omissions Clause."

Sample Errors and Omissions Clause

14 C

ERRORS AND OMISSIONS

Any inadvertent delay, omission or error shall not be held to relieve either party hereto from any liability which would attach to it hereunder if such delay, omission or error had not been made, provided such omission or error is rectified upon discovery.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/frommemcontractwd01.htm (accessed November 8, 2012). [DA09231]

COMMON REINSURANCE TREATY CLAUSES REQUIRED UNDER STATE REGULATION

Unlike primary insurance, reinsurance contracts are largely unregulated. However, state regulators influence the content of these contracts by requiring that certain clauses are included in them so that primary insurers can qualify for financial statement credit for reinsurance.

These are among the standard clauses that may be required by state regulators:

- Service of suit clause
- Insolvency clause
- Intermediary clause
- Unauthorized reinsurance clause
- Funding clause

The sample clauses included in this discussion are for illustrative purposes only and should not be relied on to construct an actual treaty.

Service of Suit Clause

A service of suit clause (sometimes called service of process clause) allows the primary insurer to seek a legal remedy from a court in a convenient jurisdiction when the reinsurance treaty involves an international reinsurer that is not licensed or otherwise authorized to sell reinsurance in the United States. It also allows the reinsurer to commence a suit in any court of its choosing in the U.S. that has jurisdiction.

Reinsurance is a worldwide business, and it is common for international reinsurers to participate in large U.S. reinsurance programs. Without the service of suit clause, the primary insurer would be forced to bring suit or respond to suits in the reinsurer's country and under that country's laws if a contract dispute could not be resolved amicably among parties to the treaty.

The service of suit clause designates an agent for service of process. Usually, the agent is a law firm that represents alien reinsurers (a reinsurer who is domiciled in a country other than the U.S.). However, the agent could be an individual or the insurance commissioner in the primary insurer's state of domicile if that state's statutes require such a designation.

Finally, the service of suit clause requires the reinsurer to abide by the final court decision, allowing, however, for an appeal.[1]

A statement at the beginning of the sample clause in the exhibit specifies that the clause applies only to alien reinsurers or unauthorized reinsurers (a reinsurer that is not licensed or authorized to do business in the primary insurer's state of domicile). This enables the clause to be used in all reinsurance treaties, regardless of whether any party is an alien or unauthorized reinsurer. See the exhibit "Sample Service of Suit Clause."

Sample Service of Suit Clause

49 A

SERVICE OF SUIT

(This Article only applies to reinsurers domiciled outside of the United States and/or unauthorized in any state, territory, or district of the United States having jurisdiction over the Company).

It is agreed that in the event of the failure of the Reinsurer hereon to pay any amount claimed to be due hereunder, the Reinsurer hereon, at the request of the Company, will submit to the jurisdiction of a court of competent jurisdiction within the United States. Nothing in this Article constitutes or should be understood to constitute a waiver of the Reinsurer's rights to commence an action in any court of competent jurisdiction in the United States, to remove an action to a United States District Court, or to seek a transfer of a case to another court as permitted by the laws of the United States or of any state in the United States. It is further agreed that service of process in such suit may be made upon (Name and Address), and that in any suit instituted, the Reinsurer will abide by the final decision of such court or of any appellate court in the event of an appeal.

The above-named are authorized and directed to accept service of process on behalf of the Reinsurer in any such suit and/or upon the request of the Company to give a written undertaking to the Company that they will enter a general appearance upon the Reinsurer's behalf in the event such a suit shall be instituted.

Further, pursuant to any statute of any state, territory or district of the United States which makes provision therefore, the Reinsurer hereon hereby designates the Superintendent, Commissioner or Director of Insurance or other officer specified for that purpose in the statute, or his successor or successors in office, as its true and lawful attorney upon whom may be served any lawful process in any action, suit or proceeding instituted by or on behalf of the Company or any beneficiary hereunder arising out of this Contract of reinsurance, and hereby designates the above-named as the person to whom the said officer is authorized to mail such process or a true copy thereof.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/frommemcontractwd01.htm (accessed November 9, 2012). [DA09202]

Insolvency Clause

Insolvency clause

A clause that is required in reinsurance agreements indicating that the primary insurer's bankruptcy does not affect the reinsurer's liability for losses under the reinsurance agreement.

The **insolvency clause** states that the reinsurer agrees to pay its reinsurance obligations under the reinsurance treaty if the primary insurer becomes insolvent, whether or not the primary insurer has paid its obligations to the underlying policyholders. This clause is required in most states and commits reinsurers to paying the state insurance department liquidator the same amount that they would otherwise have paid had the primary insurer been solvent. See the exhibit "Sample Insolvency Clause."

Sample Insolvency Clause

19 F

INSOLVENCY

In the event of the insolvency of the Company, this reinsurance shall be payable directly to the Company, or to its liquidator, receiver, conservator or statutory successor on the basis of the liability of the Company without diminution because of the insolvency of the Company or because the liquidator, receiver, conservator or statutory successor of the Company has failed to pay all or a portion of any claim. It is agreed, however, that the liquidator, receiver, conservator or statutory successor of the Company shall give written notice to the Reinsurer of the pendency of a claim against the Company indicating the policy insured which claim would involve a possible liability on the part of the Reinsurer within a reasonable time after such claim is filed in the conservation or liquidation proceeding or in the receivership, and that during the pendency of such claim, the Reinsurer may investigate such claim and interpose, at its own expense, in the proceeding where such claim is to be adjudicated, any defense or defenses that it may deem available to the Company or its liquidator, receiver, conservator or statutory successor. The expense thus incurred by the Reinsurer shall be chargeable, subject to the approval of the court, against the Company as part of the expense of conservation or liquidation to the extent of a pro rata share of the benefit which may accrue to the Company solely as a result of the defense undertaken by the Reinsurer.

Where two or more reinsurers are involved in the same claim and a majority in interest elect to interpose defense to such claim, the expense shall be apportioned in accordance with the terms of this Contract as though such expense had been incurred by the insolvent Company.

Should the Company go into liquidation or should a receiver be appointed, all amounts due either Company or Reinsurer, whether by reason of premium, losses or otherwise under this Contract or any other contract heretofore or hereafter entered between the parties (whether such contract is all assumed or ceded), shall be subject to the right of offset at any time and from time to time, and upon the exercise of the same, only the net balance shall be due.

Note: This Article does not contain "payable on demand" language in the first paragraph, nor does it contain any exceptions to payment directly to the liquidator. Offset provision in the final paragraph is for this Contract or any other contract.

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/frommemcontractwd01.htm (accessed November 9, 2012). [DA09203]

These items are specifically addressed in the "Sample Insolvency Clause" exhibit:

- Without diminution
- Notice requirements
- Right to investigate and defend
- Reimbursable expenses
- Reinsurance proceeds payable

Without Diminution

The sample insolvency clause states that the reinsurer must pay claims allowed against the insolvent primary insurer "without diminution." In other words, the reinsurer must pay the full value of claims under the treaty.

The liquidator of an insolvent primary insurer will demand full payment from a reinsurer despite the primary insurer's inability to pay all or part of an underlying claim.For example, suppose that a primary insurer (now insolvent) had an adjusted loss before insolvency of $350,000, but the loss was not paid to the claimant. The liquidator paid the claimant $262,500, or 75 percent, of the loss. The primary insurer had excess of loss reinsurance for $400,000 xs $100,000. Payment without diminution required that the excess of loss reinsurer pay $250,000 ($350,000 less the $100,000 retention) rather than $162,500 ($262,500 less the $100,000 retention). The net effect in this example was that the reinsurer paid the bulk of the loss, thereby preserving primary insurer funds to satisfy other claimants and creditors. See the exhibit "Effect of the Insolvency Clause."

Effect of the Insolvency Clause

	Primary Insurer Solvent	Primary Insurer Insolvent	
		Without Insolvency Clause	With Insolvency Clause
Loss payable	$350,000	$262,500	$262,500
Reinsurer	250,000	162,500	250,000
Primary insurer/ Liquidator	100,000 (retention)	100,000 (retention)	12,500

[DA09204]

Notice Requirements

The liquidator must notify the reinsurer of a pending claim so that the reinsurer has sufficient time to investigate the claim and decide whether to participate in the liquidator's defense of it. Without sufficient notice, the reinsurer may find out too late that its position is prejudiced regarding the claim.

Right to Investigate and Defend

The reinsurer has the right to participate at its own expense in a claim's defense. The claim section of reinsurance treaties covering third-party insurance normally specifies this right. Even though the right is rarely included in first-party treaties, the reinsurer may become involved in the defense of first-party claims with the primary insurer's consent. This provision of the insolvency clause reaffirms a reinsurer's rights under a treaty covering third-party business and extends these rights to a treaty covering first-party insurance.

This defense provision is important because the reinsurer must pay without diminution. To protect its own interests by ensuring that a reasonable claim value is established and that reasonable defenses are pursued, the reinsurer may choose to incur the extra costs to investigate and defend claims.

Reimbursable Expenses

With court approval, the reinsurer's expenses to investigate and settle a claim can be wholly or partially reimbursable by the insolvent primary insurer. The amount is limited to the proportionate share of the benefit that accrues to the primary insurer. If the reinsurer's efforts do not reduce the full value of the claim, then no benefit is realized, and therefore no expenses are reimbursed. When two or more reinsurers are involved and a majority interest elects to investigate and defend a claim, the expenses are apportioned according to the treaty's terms as if the insolvent primary insurer had incurred them.

Reinsurance Proceeds Payable

According to the sample insolvency clause, the reinsurer pays claim amounts to the liquidator. However, many claimants of insolvent primary insurers seek payment directly from reinsurers because payments may be made more quickly and be for a larger sum than the liquidator would pay.

Depending on the primary insurer's state of domicile, the insolvency clause may contain exceptions allowing the reinsurer to pay someone other than the liquidator. An exception applies when the treaty specifically provides for payment to another payee (with a cut-through endorsement). However, the liquidator may not want such an arrangement, which does not allow the liquidator to control funds paid by the reinsurer.

The insolvency clause may not require the liquidator or court to approve the reinsurer's direct payment to an insolvent primary insurer's claimant. However, it is prudent for a reinsurer to seek such approval. Without approval, the reinsurer could find that it is still required to pay the full amount of the reinsurance recoverable to the liquidator, despite having already paid the claim in full directly to the underlying insured on behalf of the insolvent primary insurer.

Intermediary Clause

Intermediary clause

A clause that is required in reinsurance agreements indicating that the reinsurance intermediary is the reinsurer's agent for collecting reinsurance premiums and paying reinsurance claims.

State insurance regulators typically require that an intermediary clause be included whenever a reinsurance intermediary is involved in a reinsurance transaction. The **intermediary clause** requires the reinsurer to accept financial responsibility (the credit risk) for funds transferred from the primary insurer to the reinsurer through a reinsurance intermediary. The National Association of Insurance Commissioners (NAIC) Financial Condition Examiners Handbook requires such wording for insurers to take credit for reinsurance on their financial statements.[2] Problems have arisen in some states whose statutes do not address the NAIC handbook.

The intermediary clause identifies the reinsurance intermediary by name and asserts that all communications must be channeled through the reinsurance intermediary. Communications can include notices, statements, premium, return premium, commissions, taxes, losses, loss adjustment expenses, salvages, and loss settlements. It is common for the primary insurer to have direct contact with the reinsurer without the reinsurance intermediary actively participating in the dialogue. However, the reinsurance intermediary should be kept fully informed of the details of such communications.

The intermediary clause further states that payments made by the primary insurer to the reinsurance intermediary constitute payment to the reinsurer. However, payments made by the reinsurer to the reinsurance intermediary constitute payment to the primary insurer only to the extent to which they are actually received by the primary insurer. For most purposes, the reinsurance intermediary is the primary insurer's agent, not the reinsurer's agent. However, the intermediary clause requires the reinsurer to take the credit risk if the reinsurance intermediary becomes insolvent, which, for this purpose, makes the reinsurance intermediary the reinsurer's agent. See the exhibit "Sample Intermediary Clause."

Unauthorized Reinsurance Clause

Unauthorized reinsurance clause

A reinsurance treaty clause required by state insurance regulation that specifies those requirements that an unauthorized reinsurer must satisfy in order for the transaction to receive favorable accounting treatment as a reinsurance transaction.

The **unauthorized reinsurance clause** specifies those requirements that an unauthorized reinsurer must satisfy in order for the transaction to receive favorable accounting treatment as a reinsurance transaction.

State insurance regulators require the inclusion of this clause in reinsurance treaties because of the effect that uncollectable reinsurance has had on the

Sample Intermediary Clause

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INTERMEDIARY

(Intermediary Name) is hereby recognized as the Intermediary negotiating this Contract for all business hereunder. All communications (including but not limited to notices, statements, premium, return premium, commissions, taxes, losses, loss adjustment expense, salvages and loss settlements) relating thereto shall be transmitted to the Company or the Reinsurer through (intermediary Name and Address). Payments by the Company to the Intermediary shall be deemed to constitute payment to the Reinsurer. Payments by the Reinsurer to the Intermediary shall be deemed to constitute payment to the Company only to the extent that such payments are actually received by the Company.

Brokers and Reinsurance Markets Association (BRMA), www.brma.org/frommembers/frommemcontractwd01.htm (accessed November 9, 2012). [DA09205]

solvency of primary insurers. Because unauthorized reinsurers are not licensed to operate in the primary insurer's state of domicile, state insurance regulators have no direct regulatory authority over them. The unauthorized reinsurance clause, and the state insurance regulations supporting it, give state insurance regulators some indirect control over unauthorized reinsurers.

The unauthorized reinsurance clause requires primary insurers to withhold reinsurance premium owed to unauthorized reinsurers until the reinsurer's obligations for outstanding losses and loss adjustment expenses (including incurred but not reported loss reserves) are either satisfied or extinguished.

As an alternative to totally funding these obligations through a separate reserve on its books, the primary insurer can obtain a letter of credit from the reinsurer or other proof of collateral acceptable to state insurance regulators. See the exhibit "Sample Unauthorized Reinsurance Clause (Excerpt)."

Funding Clause

NAIC has adopted revisions to the Credit for Reinsurance Model Law and Credit for Reinsurance Model Regulation to reduce reinsurance collateral requirements for reinsurers that meet certain criteria. States can choose to certify reinsurers according to the NAIC model law and regulation, at which point **certified reinsurers** are rated and have their collateral requirements adjusted accordingly. However, primary insurers ceding to certified reinsurers must have funding clauses in their reinsurance agreements that require security by the reinsurers in amounts appropriate to their ratings to avoid financial statement penalties.

Certified reinsurer

An unauthorized reinsurer that meets certain qualifications and is approved by the state insurance regulator of the ceding company's state of domicile.

Sample Unauthorized Reinsurance Clause (Excerpt)

55 A

UNAUTHORIZED REINSURANCE

(Applies only to a Reinsurer who does not qualify for full credit with any insurance regulatory authority having jurisdiction over the Company's reserves.)

As regards policies or bonds issued by the Company coming within the scope of this Contract, the Company agrees that when it shall file with the insurance regulatory authority or set up on its books reserves for unearned premium and losses covered hereunder which it shall be required by law to set up, it will forward to the Reinsurer a statement showing the proportion of such reserves which is applicable to the Reinsurer. The Reinsurer hereby agrees to fund such reserves in respect of unearned premium, known outstanding losses that have been reported to the Reinsurer and allocated loss adjustment expense relating thereto, losses and allocated loss adjustment expense paid by the Company but not recovered from the Reinsurer, plus reserves for losses incurred but not reported, as shown in the statement prepared by the Company (hereinafter referred to as "Reinsurer's Obligations") by funds withheld, cash advances or a Letter of Credit. The Reinsurer shall have the option of determining the method of funding provided it is acceptable to the insurance regulatory authorities having jurisdiction over the Company's reserves.

When funding by a Letter of Credit, the Reinsurer agrees to apply for and secure timely delivery to the Company of a clean, irrevocable and unconditional Letter of Credit issued by a bank and containing provisions acceptable to the insurance regulatory authorities having jurisdiction over the Company's reserves in an amount equal to the Reinsurer's proportion of said reserves. Such Letter of Credit shall be issued for a period of not less than one year, and shall be automatically extended for one year from its date of expiration or any future expiration date unless thirty (30) days (sixty (60) days where required by insurance regulatory authorities) prior to any expiration date the issuing bank shall notify the Company by certified or registered mail that the issuing bank elects not to consider the Letter of Credit extended for any additional period.

The Reinsurer and Company agree that the Letters of Credit provided by the Reinsurer pursuant to the provisions of this Contract may be drawn upon at any time, notwithstanding any other provision of this Contract, and be utilized by the Company or any successor, by operation of law, of the Company including, without limitation, any liquidator, rehabilitator, receiver or conservator of the Company for the following purposes, unless otherwise provided for in a separate Trust Agreement:

(a) to reimburse the Company for the Reinsurer's Obligations, the payment of which is due under the terms of this Contract and which has not been otherwise paid;

(b) to make refund of any sum which is in excess of the actual amount required to pay the Reinsurer's Obligations under this Contract;

(c) to fund an account with the Company for the Reinsurer's Obligations. Such cash deposit shall be held in an interest bearing account separate from the Company's other assets, and interest thereon not in excess of the prime rate shall accrue to the benefit of the Reinsurer;

(d) to pay the Reinsurer's share of any other amounts the Company claims are due under this Contract.

Brokers and Reinsurance Markets Association (BRMA), www.brma.org/frommembers/frommemcontractwd01.htm (accessed November 9, 2012). [DA09206]

INTERESTS AND LIABILITIES AGREEMENT

A separate agreement is commonly attached to a reinsurance treaty in which more than one reinsurer participates.

The interests and liabilities agreement, also known as ILA, is not a reinsurance treaty clause but a separate agreement, attached to and forming part of a reinsurance treaty in which multiple reinsurers participate, that controls the participation and liability of each reinsurer. In particular, it serves these purposes:

- Identifies the treaty to which it applies
- Identifies parties to the applicable treaty
- States the percentage of participation for individual reinsurers
- Establishes that **several liability**, not **joint liability**, applies to each reinsurer
- States an effective date
- Provides for proper execution by authorized officers of the primary insurer and each reinsurer

Several liability
Liability of a party for only the part of the total obligation that represents its participation.

Joint liability
Liability of two or more parties in which they share responsibility for the entire obligation.

The interests and liabilities agreement controls each reinsurer's liability under the multiparty reinsurance treaty in two ways. First, it specifies a percentage of participation for each reinsurer. Second, it specifies that the reinsurer's participation is several not joint with the other reinsurers participating in the reinsurance treaty. Because of the several liability provision, the failure of one reinsurer to meet its obligation to indemnify the primary insurer will not increase the liabilities of the other reinsurers.

If the several liability principle were not used when multiple reinsurers participated in a loss exposure, a single reinsurer could be called on to meet the obligations of one or more of its co-reinsurers. The reinsurer could be liable for the entire loss exposure and receive only a portion of the reinsurance premium.

If only one reinsurer is involved in a reinsurance treaty, the interests and liabilities agreement is not needed. However, many reinsurance treaties, particularly those placed by reinsurance intermediaries, involve participation from multiple reinsurers. Reinsurers that want to participate to a limited extent in large treaties can do so with certainty about their obligations because of the inclusion of the interests and liabilities agreement. See the exhibit "Sample Interests and Liabilities Agreement Example."

Sample Interests and Liabilities Agreement Example

BRMA 21 A

INTERESTS AND LIABILITIES AGREEMENT

to

(insert the title of heading of the Reinsurance Contract which is the subject of the ILA

e.g. "First Catastrophe Excess Reinsurance Contract")

_____

(hereinafter referred to as the "Contract")

between

(insert the name(s) of the Company(ies)

(hereinafter referred to individually or collectively as the "Company")

and

(insert the name of the Reinsurer)

(hereinafter referred to as the "Subscribing Reinsurer")

Under the terms of the Contract, which is attached to this Agreement, the Subscribing Reinsurer agrees to participate in a _____% share of the interests and liabilities of the Reinsurer(s) described in the Contract. The participation of the Subscribing Reinsurer shall be several and not joint with any other reinsurers participating in the Contract.

This Agreement shall become effective _____ and shall expire _____.

Signed in *(duplicate, triplicate, or whatever is appropriate)*

in *(City, State)*, this day of *(month), (year)*.

(Subscribing Reinsurer)

By _____

Title _____

Signed in *(duplicate, triplicate, or whatever is appropriate)*

in *(City, State)*, this day of *(month), (year)*.

(Company)

By _____

Title _____

Brokers & Reinsurance Markets Association (BRMA), www.brma.org/frommembers/contractword/Interest%20and%20Liabilities%20Agreement%20BRMA%2021A-C.doc (accessed November 9, 2012). [DA09152]

SUMMARY

Each reinsurance treaty's wording is unique because it states the intent of the parties to that particular treaty. However, some clauses are common to most reinsurance treaties and are necessary for the treaty to function. Understanding these common clauses is essential to understanding the rights and duties of the parties to the treaty: preamble, affiliated companies clause, reinsuring clause, definitions clause, access to records clause, federal excise tax clause, currency clause, governing law clause, exclusion clauses, arbitration clause, offset clause, and errors and omissions clause.

To qualify for financial statement credit for ceded reinsurance, primary insurers are required by their states to include standard clauses that address the states' concerns regarding primary insurers' solvency. Typical standard clauses required by states include those regarding service of suit, insolvency, intermediaries, unauthorized reinsurance, and funding.

The ILA is a separate agreement, attached to and forming part of a reinsurance treaty, that controls the participation and liability of each reinsurer participating in the reinsurance treaty. ILAs are common when multiple reinsurers participate in a treaty.

ASSIGNMENT NOTES

1. The National Association of Insurance Commissioners (NAIC) Reinsurance Task Force has established an Enforceability of Foreign Judgments Subgroup to determine what difficulties can occur in collecting from alien jurisdictions. Particular difficulties have been experienced concerning default judgments, arbitral awards, and punitive damages. For example, Germany does not recognize punitive damage awards from U.S. courts.
2. National Association of Insurance Commissioners, NAIC Financial Condition Examiners Handbook (2012), http://www.naic.org/committees_e_examover_fehtg.htm, p. 111.