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A perfect storm?

The 2008 renewal season is certainly living up to its predictions as being one of the most interesting in recent years. Market conditions remain uncertain following the near collapse of AIG and no week passes without further developments and breaking news.

These market events are of course outside the control of most underwriters and cedants. What does remain in their control is to ensure that their contract documentation accurately reflects the risk renewed and the terms and conditions agreed. In this edition of RIRt Notes, we set out some practical tips for underwriters and cedants to consider when renewing their contracts and writing new business. We also consider specific wordings and clauses that, in other times, would be considered boilerplate and mundane: termination, downgrade, insolvency and set-off provisions. AIG's high profile near collapse has reminded us that nothing can be taken for granted.

On a more specific level, it remains to be seen how the credit crunch and sub-prime crisis will affect the reinsurance market. We review some of the potential sources of the mis-selling claims that may arise in the future, and some of the reinsurance issues that are likely to be in issue (in particular claims notification).

Of course, the credit crunch has not been the only story of 2008. Hurricanes Ike and Gustav reminded the market that catastrophes remain a major concern. We consider the issue of causation and how the cause of each loss can be a significant factor in assessing coverage. We also consider the current market for ILS products, particularly in light of some recent high profile downgrades.

Finally, it is worth remembering that mediation remains an effective tool to resolve any disputes that may arise. Earlier this year, the European Parliament approved the Mediation Directive and we consider its likely impact upon the reinsurance market. ■

The Reinsurance and International Risk team

The credit crunch - clauses to consider this renewals season

As the credit crunch has deepened, its effects have rippled outwards. The sub-prime crisis in the US, market losses and failing confidence in the banking market have led to rating downgrades, emergency raising of capital and, ultimately, state intervention.

The insurance market has not been immune, AIG's high-profile failure being the paradigm example that the security of even the largest insurers may fail.

This renewal season more than in previous years clauses which in better times might have been treated as little more than "boilerplate" will come under much greater scrutiny. With deals unwinding, contracts being cancelled and the spectre of insolvency looming large, we focus here on termination, downgrade, insolvency and set-off clauses, the issues arising from them and their potential importance for reinsurance contracts.

Termination clauses

Termination clauses in reinsurance contracts will be of particular relevance in contracts written on a long-term or continuous basis. Generally, long-term reinsurance contracts provide for either a Notice of Cancellation at Anniversary Date (NCAD) or a Provisional Notice of Cancellation (PNOC). The difference between the two is that, once a PNOC has been given, a consultation process between the reinsured and the reinsurer follows to decide whether the contract should be continued past its anniversary date. This consultation period also gives each party the opportunity to reassess the credit worthiness and financial strength of the other. NCAD clauses, by contrast, simply allow the reinsurer to cancel the reinsurance with effect from its anniversary date, provided notice is given not later than the date specified in the clause (for example 90 or 120 days). Reviewing and possibly terminating a reinsurance contract close to its anniversary date may, however, prove too late to make alternative arrangements considering the fast pace at which some reinsureds and reinsurers have become a higher credit risk in the current economic conditions. For Lloyd's Market reinsureds, the loss of a major reinsurance contract may be a matter which will need to be reported to the Franchise Board under the requirements of the Underwriting Byelaws.

General termination provisions, allowing termination of the contract after a specified notice period, may be helpful, and parties will need to ensure that these strike the right balance between flexibility to cancel reinsurance arrangements and promoting certainty of ongoing cover, or at least give sufficient time for the reinsured to source alternative reinsurance.

Downgrade clauses

A downgrade clause is an exit option linked to the financial strength of either party, which can be triggered at any time during the duration of the contract, complements a general notice of termination.

Unsurprisingly, there has been a surge in requests from reinsureds and brokers for downgrade clauses to be inserted into reinsurance contracts, which usually allow the reinsured, or alternatively either party, to terminate the contract if the reinsurer suffers a rating downgrade. A reinsured may see such a term as reducing its exposure to its reinsurer's credit risk and of protecting the value of its reinsurance programme. However, downgrade clauses could sit awkwardly in the relationship between reinsureds and reinsurers, and set out below are some of the factors which parties should bear in mind when considering possible downgrade clauses:

- most downgrade clauses give the reinsured the option to terminate the contract. By doing so, of course, a reinsured's own rating may be affected if the level of its reinsurance declines;
- the period in which the reinsured may exercise its option to terminate the contract must be adequately defined;
- alternatives to termination in case of a rating downgrade should be considered, such as a provision for additional

security; and
- termination will result in a pro-rata refund of premium and a cap on the reinsurer's exposure.

The parties' bargaining power will decide the shape of these clauses. The extent to which they become a standard feature within reinsurance contracts this renewal season remains to be seen.

Insolvency of reinsurers

Parties to reinsurance contracts will need to be aware of the order of priority given to creditors in the winding-up of a UK insurer, set out in the Insurers (Reorganisation and Winding Up) Regulations 2004 ("the Reorganisation Regulations").

The Reorganisation Regulations do not apply to pure reinsurers, but provide for super-priority for "insurance debts" of a UK insurer, which would not apply on a general insolvency.

An "insurance debt" is a debt for which a UK insurer is or may become liable, pursuant to a contract of insurance, to a policyholder or to any person who has a direct right of action against that insurer. It includes premium paid which the insurer may be liable to refund. The definition of "insurance debt" excludes reinsurance claims.

The exclusion of pure reinsurers and reinsurance claims from the Reorganisation Regulations has certain commercial ramifications. Reinsureds frequently take into account prospective reinsurers' security when placing business. If a reinsured has bought reinsurance from a company that writes, or is authorised to write, both direct insurance and reinsurance, then its reinsurance recoveries may be adversely affected if the reinsurer encounters financial difficulties, as those with "insurance debts" (i.e. direct policyholders) will be able to take advantage of the super-priority, potentially exhausting the company's funds before any reinsurance recoveries can be made.

Reinsureds may therefore try to negotiate price readjustments, or avoid buying reinsurance from any company other than a pure reinsurer. Correspondingly, reinsurers which also write insurance business often split the business so that separate entities write either solely reinsurance or solely insurance business.

Insolvency clauses

Insolvency clauses generally provide, among other things, that on the reinsured's insolvency, reinsurance recoveries are still payable to it (or its liquidator), notwithstanding the insolvency. Historically, such claims operated on a "pay as paid" basis; the reinsured was obliged to pay underlying claims before being able to recover under the reinsurance. This meant that liquidators of insolvent reinsureds could not access reinsurance recoveries if they were unable to pay underlying claims first.

In Charter Re v Fagan (1996), however, the House of Lords established that the trigger for reinsurance recoveries becoming collectible should be the establishment of the reinsured's liability to pay its policyholders, rather than actual payment. Insolvency clauses now reflect this position and the fact that the reinsurer is liable to pay the reinsured even though the reinsured is unable to pay its policyholder first by reason of its insolvency.

Set-off clauses

Set-off clauses allow a reinsurer to set off any amounts due from a reinsured against any amounts which are or may become due to it. This is particularly useful where an insolvent reinsured has defaulted, or is at risk of defaulting, on premium payments.

However, such clauses may be void if they purport to give greater rights than those allowed under the Insolvency Rules 1986. Rule 4.90(3) of the Rules (which is mandatory and cannot be excluded by contract) provides that "An account shall be taken of what is due from each party to the other in respect of the mutual dealings, and the sums due from one party shall be set off against the sums due from the other." Any sums due from the insolvent party in excess of that which is owed to it by the solvent party must be proved for in the liquidation in the ordinary way. Similarly, if the solvent party owes to the insolvent party more than the insolvent party owes to it, it must pay the balance to the liquidator. ■

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Natural catastrophes - the causation conundrum

When a disaster strikes, the insurance industry is expected to respond quickly and decisively. Unfortunately, the factual chaos which often results is frequently accompanied by coverage issues.

A recurring issue is causation due to the chain of events leading to loss, for example, an earthquake which leads to a tsunami which leads to flooding.

Determining cause of loss can be a conundrum due to the way in which the law approaches causation. We summarise below relevant principles plus contractual drafting tips. The starting point is that an insurer is only liable for losses caused by an insured peril. However, a loss may have a range of possible causes depending on how far back in time one goes. As one judge put it in relation to an insurance contract, "...the chain of causation recedes infinitely into the past. The draftsman must have intended to stop somewhere: and that place must be the point at which an event ceases to be a cause of the loss, and becomes merely an item of history."

Rather than adopt simpler tests for causation such as the peril first or last in time, we have, under English law, the doctrine of "proximate cause" which has been explained as the "dominant" or "efficient" cause.

There is no recent English case law on proximate cause in a catastrophe context. In the leading case Leyland v Norwich Union (1918), a vessel was torpedoed by a German submarine in WW1. Towed to Le Havre, she could have been repaired if allowed to stay. However, the port authorities were concerned that she might sink and block the port so they ordered her out. A gale blew up and after being buffeted by wind and waves, she sank. Instead of finding the proximate cause of loss was "perils of the sea", the court held it was "war", an excepted peril.

So, although the doctrine of proximate cause is theoretically easy, it may be difficult to predict how far back in time a court will go in selecting from a range of possible causes.

What if there are two proximate causes operating concurrently with equal dominance? This can be critical if one is covered and the other excluded or simply uninsured. Thankfully, English law provides straightforward answers. Where one cause is covered and the other uninsured, the general principle is that the cover responds to the entire loss – The Miss Jay Jay (1987). Where one cause is covered and the other specifically excluded, the cover does not respond at all – Wayne Tank (1974).

The ability to reach back into time when determining proximate cause and the qualitative nature of the definition as "efficient" and "dominant" means that how you characterise your argument is important. Although there is a legal framework for determining cause of loss, a skilfully crafted presentation can characterise loss in the most advantageous way. Early and appropriate legal input can be critical.

It is possible to craft your wordings so as to tilt the causation argument in your favour. For example, the insuring clause could provide that the policy responds only to loss caused "solely and directly" by a covered peril. Conversely, it could provide that the policy responds if loss is caused "directly or indirectly" by a covered peril. Similarly, one could totally exclude loss resulting "directly or indirectly" from named perils. Conversely, excluding loss resulting "solely and directly" from excepted perils narrows operation of exclusions.

Finally, it is possible contractually to reverse the natural burden of proof. For example, the burden of proving an exclusion applies normally rests with the (re)insurer. It is, however, contractually possible to provide that the burden of showing that an exclusion **does not apply** rests with the (re)insured. Obviously, such provisions should be limited to exclusions reasonably identified by the (re)insurer as applicable. ■ Yvonne Jefferies and James Thomas

Continued convergence of the reinsurance and capital markets?

Such was the demand for Catastrophe Bond issuance during 2006/2007 that some feared the worst for the future of the traditional reinsurance/retrocession sector. How seriously has confidence in ILS products been dented by recent market developments, including the downgrading of four catastrophe bonds?

The insurance-linked securities (ILS) market has grown significantly in recent years.

Companies have found access to new security and capital at a time when the cost of traditional reinsurance made new capital solutions more attractive. Investors have been able to expand their portfolios into areas uncorrelated with the risks assumed in the wider financial markets.

What, however does the future hold for these products in the current economic climate? In October, Standard & Poor's downgraded the four catastrophe bonds that used Lehman Bros Special Financing as the total return swap counterparty. Will this development dampen appetites for ILS products or will investors consider this to be an aberration and retain the conviction that these products provide secure risk transfer mechanisms because of their collateralized nature?

Following the devastating hurricane seasons of 2004 and 2005, rating agencies increased capital requirements for catastrophe-exposed underwriters. The result was a surge in demand and a simultaneous contraction in the provision of reinsurance capacity. The market hardened. (Re)insurers turned to the capital markets to supplement their cover. Since that time, the growth in the ILS market has also been driven by capital market investors looking to diversify their interests. Available alternative products include catastrophe bonds and industry loss warranties (ILWs).

In a catastrophe bond transaction, a reinsurance contract is entered into between the reinsured and a Special Purpose Vehicle (SPV). The SPV sells bonds to investors and these bonds pay out (less commonly) on an indemnity basis, or upon the happening of an indexed, modelled, or parametric trigger. Investors' exposure is to losses paid by the SPV under the reinsurance contract. ILWs come in many shapes and sizes. They provide cover for losses from events where the industry-wide insured loss exceeds a pre-agreed marker. ILWs documented in reinsurance form must have an insurable interest. The contract must stipulate two triggers; the first being the industry-wide loss, the second relating to the reinsured's own account. With both catastrophe bonds and ILWs there is a risk that the index calculation which triggers payment will not match the reinsured's actual loss (the basis risk). It is not an issue with traditional reinsurance products. To help alleviate the basis risk, more sophisticated hybrid triggers have been developed. These have yet to be put to the test and rating agencies do not give full capital credit for parametric or modelled bonds because of the basis risk. A further downside with catastrophe bonds is that they tend to involve higher up-front costs than traditional reinsurance.

The obligation remains on the reinsured purchasing cover through one of these ILS products to disclose all material facts within its knowledge that are relevant to the risk. However, where the level of losses which will activate the trigger relating to the reinsured's own account is considerably lower than that relating to the industry-wide loss, then what the reinsured has to disclose is less likely to be deemed "material". A notable advantage of catastrophe bonds (and some ILWs) is that they provide full collateralization of losses. In the current climate, companies with eroded capital basis may be attracted by the added security this provides.

Catastrophe bonds and ILWs are better understood, less correlated with other financial products and generally more transparent than the securitised retail mortgage backed securities which lie at the root of the current economic crisis. They should not be tarred with the same brush. ■

David Abbott and Tracey Anderson

Care and caution at renewal

This renewal season, more than any in the past few years, will be a fraught one. While care must always be taken at renewal time, this year extreme caution will be necessary.

Changing circumstances in the market will require a substantial amount of last minute detailed negotiation and, most probably, a considerable degree of replacement security. Added to all of this, leaner times will mean that risks will be written into a more uncertain and litigious environment than has been the case in recent years.

There are a number of steps that must be taken to ensure that the bargain struck between reinsured and reinsurer is not only valid but is enforceable in the way that the parties wish it to be enforced. If a contract works in the expected manner, the scope for later dispute is less.

The first step is to ensure that the renewal presentation is accurate. Where limits and retentions are altered, ensure that this is reflected in any figures presented. Ensure that claims information is accurate and updated. Nothing leads to claims of non-disclosure or misrepresentation like a non-notified major loss. Estimates of premium income are difficult in rapidly changing economic circumstances. Check that they are as accurate as they can be and warn as to any foreseeable circumstances that might lead them to rise or fall.

One particular point with respect to placement is that, if one has any doubt about whether it is necessary to disclose a particular fact or circumstance, disclose it. It is better to have a risk rejected by reinsurers than subsequently avoided. One can always restructure, re-price and replace before inception.

The wording is vital. Check it and have it reviewed by your legal team. Even wordings that have existed for many years may contain ambiguities or inaccuracies that require correction. Where a risk is being altered or restructured, ensure that the alterations are accurately reflected. Most of all, make sure that the proper law and jurisdiction of the contract is expressed. These seeming "boilerplate" clauses can alter the entire meaning and enforceability of the contract.

With contract certainty, there is no reason why a wording should not be drawn up ready for presentation at the same time as the slip. Ensure that the wording and slip coincide and complement each other and that no contradictions exist. Particular care should be taken to ensure that aggregation clauses reflect the pricing of the risk and that follow the fortunes/settlements provisions do not contradict claims control or claims co-operation wordings. When agreeing wordings, also be careful to ensure that they dovetail either into the underlying covers that they are to protect or the reinsurances that are to protect them. Where standard market wordings are used, ensure that the correct form is used and that it dovetails into the rest of the wording. Ideally, copy and paste clauses rather than simply using reference numbers. It takes a little more time but can save confusion and error.

Never leave anything to a general understanding. Express it in the wording. Do not use side letters or agreements. If something is agreed, it should form part of the contract. Make notes of all discussions with brokers or the counterparty. Ideally, express these in confirmatory e-mails to the person with whom one has met. This way there can be no confusion later as to what was said and what was relied upon.

A little time and effort at renewal may save considerable expense and years of litigation and may help ensure that a reinsurance contract operates in the way that it is intended. ■ Clive O'Connell and John Whelan

Known knowns, known unknowns and unknown unknowns

There can be no doubt how hard the sub-prime crisis and the ensuing credit crunch have hit the financial markets. Similarly, insurers and reinsurers have been damaged (some critically so) by their investment strategies. Commentators believe that further damage will follow when the full impact of claims arising from the economic meltdown is felt.

Human nature will lead investors to look for someone, anyone, to blame for negative investment returns. Invariably, investors' fingers will point at those with whom they have a direct connection and more particularly those with deep pockets, for example intermediaries and financial advisers.

Already this year, the Financial Services Authority has acted against advisers regarding the mis-selling of self-certified mortgages and various lenders regarding PPI mis-selling. These actions may yet lead to legal proceedings, in the form of either common law/statutory misrepresentation claims or claims based on regulatory obligations. The sheer size of the penalties imposed highlights the exposures potentially faced by professional indemnity insurers of intermediaries and financial advisers (and, in turn, reinsurers picking up such exposures). It has been a busy decade for the PI market as it has faced the fall-out from the pensions and mortgage endowment mis-selling sagas.

Confronted by the spectre of mis-selling claims, many insurers and reinsurers are considering their positions, although few proceedings have yet been issued. Consequently, it is impossible to say with certainty what legal issues will arise. If the pattern of past mis-selling crises is repeated, aggregation and notification, in particular, may present difficulties.

Aggregation is likely to be an issue since there will be thousands of individual claims. Recent English decisions reveal an unreceptive approach to insureds/reinsureds arguing for the aggregation of several small claims where the policy is subject to a large deductible. The leading authority remains Lloyds TSB v Lloyds Bank Group Insurance (2003) which arose from the mis-selling of personal pensions. The policy provided that various third party claims resulting from any single act/omission (or related series of acts/omissions) could be considered a single claim for the purposes of the deductible. The court held that underlying acts/omissions could form a related series only if their combined operation resulted in each claim (a most unlikely scenario). More recently, Standard Life v Oak Dedicated (2008) considered the mis-selling of mortgage endowment policies. The policy carried an excess of "£25m each and every claim and/or claimant", which was held to mean the excess applied to each individual claim. Faced with aggregation issues, the courts examine the aggregating words in minute detail and apply the particular facts to that wording. Anticipating how a particular aggregation clause will apply to a particular set of facts remains difficult.

Notification provisions, commonplace in reinsurance contracts, are often expressed as conditions precedent. It can be crucial to determine whether a notification clause has been complied with as breach will allow reinsurers to reject the claim. Standard clauses require notification to reinsurers upon knowledge of any losses which may give rise to a claim. In AIG v Faraday (2007), the Court of Appeal held that 'loss' meant not the reinsured's settlement but the underlying loss which might lead to legal proceedings. In this situation, reinsureds face some difficulty deciding when to notify. Certainly, they should consider notifying early, although no claim/loss may develop.

Insurers and reinsurers are well advised to review their wordings, focusing on the above as well as claims control and follow the settlements provisions. ■ Leigh Williams and Ian Plumley

The European Mediation Directive

The European Parliament and Council of Europe have earlier this year promoted the use of mediation as an alternative method of settling civil and commercial disputes to give better access to justice, through The Mediation Directive 2008/52/EC.

Used properly and at the right time, mediation is an effective method of resolving disputes, which should be considered by a reinsurer.

The English court has encouraged alternative dispute resolution, including mediation, since the mid 1990s, and the reinsurance market has been a strong supporter of the mediation process.

The Directive, which applies only to cross border disputes, has yet to be enacted by the UK Parliament, with compliance due by 2011. However, the Directive's main provisions will be familiar to reinsurers who use the mediation process in the UK.

- A court (but notably not an arbitration panel) may invite parties to use mediation, although national laws can make mediation compulsory or subject to incentives or sanctions, provided there is always access to the justice system.
- Any agreement arising out of the mediation (for example a settlement agreement) shall be enforceable in the Member States, with a status similar to a judgment.
- The mediation process shall be confidential, and anything said by the mediator or parties at the mediation cannot be used in judicial proceedings.
- Most importantly, a party choosing mediation shall not be prevented from issuing legal or arbitration proceedings by reason of limitation expiring during the mediation process (subject to any international agreement).

Overall, the Directive is to be welcomed as it gives further encouragement to parties to mediate. However, we must wait and see whether the UK Parliament takes this opportunity to enact legislation which covers domestic disputes as well as cross border disputes, and which adopts a stronger line than the Directive. ■ Janet Lambert and Kiran Soar

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