TREATY CLAUSES:
EXTRA-CONTRACTUAL OBLIGATIONS CLAUSE

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Abstract: This is the third in a recurring series of articles focusing on reinsurance treaty clauses most useful to claims professionals. Authored by a member of the Journal of Reinsurance’s Industry Advisory Panel, this article addresses how best to interpret and draft the Extra Contractual Obligations Clause. This article provides pragmatic advice as to how claims executives can avoid issues with application of the Extra Contractual Obligations Clause.

My latest promise is kept—last quarter’s column on the Excess of Policy Limits (XPL) Clause is followed this quarter by an explanation of how best to draft and interpret the related but different Extra-Contractual Obligations (ECO) Clause.

Of necessity, I am also keeping an earlier promise, made at the time this column was first envisioned. This initial promise was to provide practical advice to the reinsurance claims executive as to those claims-related clauses about which little legal precedent has developed. No lengthy case analyses on the follow-the fortunes clause or arbitration clause for this column! The ECO clause is uniquely suited to such an examination. With the exception of the eighteen year old case of Hartford Fire Ins. Co vs., Lloyd’s Syndicate 0056 Ash,1 which holds that a reinsurer must pay ECO damages to its cedent-under certain circumstances—even when underlying punitive damages are awarded in a jurisdiction prohibiting insurability of punitive damages, the courts have recently been silent as to how to apply the ECO clause in problematic situations. The wise reinsurance claims executive suspects that controversies about ECO do exist between a cedent and its reinsurer(s), but that such disputes are resolved by the fact-specific and confidential means of arbitration.

1. INTRODUCTION TO THE ECO CLAUSE

With both the XPL and ECO clauses, out the window goes the basic precept that reinsurers must indemnify only to the extent that the cedent’s payments are within the scope of the reinsured policy’s terms.2 The difference between the two is the difference between contract and tort. Typically, the XPL loss arises because a third party claimant recovers damages against a cedent’s insured. But for the limits of the insurance policy or contract, the damages would be covered by the reinsured insurance policy. By contrast, the ECO loss arises because an insured itself alleges bad acts on the part of its insurer, also known as the cedent. The full panoply of incidents of alleged or actual “bad faith” on the part of the cedent is codified in each state’s Unfair Claims Practices Acts. Central to the tortious behavior of the cedent is the failure to meet its separate duties to investigate, defend and indemnify the insured and—where policy limits are implicated by a claim—to appropriately settle a loss.

Bad faith as a cause of action now exists in all U.S. jurisdictions, but likely originated as a separate and actionable tort against an insurer in California in the 1960’s.3 Along with the advent of the independent tort of bad faith came the necessity on the part of the cedent to spread and diversify the risk by transferring it to its reinsurer(s). From the reinsurer’s point of view, this transfer of risk does not constitute aiding and abetting inappropriate actions on the part of the cedent/insurer.4 Rather, the provision of ECO coverage is a tacit recognition that (i) even well-run cedents may analyze a case and its related obligations in error and (ii) that, in U.S. jurisdictions, these errors may have very expensive consequences by way of damages.

2. THE CONTEMPORARY ECO TREATY CLAUSE

In last quarter’s column, we referenced Brokers and Reinsurance Markets Association (BRMA) Clause 15 C for having the requisite elements of a well-drafted XPL clause in an excess of loss treaty.

CONTINUED ON PAGE 10

4 Per the New York State Insurance Department, for example, the provision of ECO coverage does not breach statute or regulation. See State of New York Insurance Dept., Office of General Counsel opinion, dated November 18, 2002.
Let’s use the following ECO clause this quarter. While not contained in the BRMA portfolio of clauses, this particular excess of loss treaty clause sets forth the percentage of ECO risk to be transferred to the reinsurer as well as all other necessary elements.

A. This Contract shall protect the Company within the limits hereof for __% for any Extra Contractual Obligations, where the Ultimate Net Loss includes any Extra-Contractual Obligations.

B. “Extra-Contractual Obligations” are defined as those liabilities not covered under any other provision of this Contract and which arise from the handling of any claim on business covered hereunder, such liabilities arising because of, but not limited to the following: failure by the Company to settle within the policy limits, or by reason of actual negligence, or by reason of legal or actual negligence, fraud or bad faith in rejecting an offer of settlement or in the preparation of the defense or in the trial of any action against its insured or reinsured or in the preparation or prosecution of an appeal consequent upon such action.

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

D. Recoveries, collectibles or retention from any other form of insurance or reinsurance including deductibles, or self-insured retention which protect the Company against claims, which narrows coverage to just that which the cedent would be obliged to pay but for the limit of the reinsured policy, the scope of the ECO Clause’s coverage broadens to encompass “those liabilities not covered under any provision of this Contract.” We are clearly focusing on tortious conduct of the cedent, not that originating from the terms of the reinsured insurance policy itself.

3. DRAFTING OBSERVATIONS
ECO CLAUSE VS. XPL CLAUSE

a. The Co-Insurance Percentage

The extended soft market from 2003-11 produced some excess of loss treaty clauses providing that the reinsurer(s) would assume 100% of the ECO risk. Much more common today is the ECO clause specifying that the specific cedent retains some 10-20% of the extra-contractual risk.

Why is this prudent? Just as I stated that a reinsurer does not ordinarily suspect that its cedent will fail to appropriately investigate, defend and indemnify its insureds, a savvy reinsurer will want to make sure that its individual cedent has some financial incentive to refrain from bad faith actions. Very similar indeed to Ronald Reagan’s maxim “trust but verify”. By leaving a 10-20% co-insurance percentage with the cedent, the reinsurer assures that (i) there is little potential for moral hazard and (ii) the cedent’s interests are aligned with its own.

This should not be the only means by which the reinsurer’s claims executive should protect his or her employer. By monitoring claims that are submitted from the cedent (optimally through just one or two analysts), the reinsurer’s claims executive will be able to determine whether the cedent is presenting a disproportionate amount of bills that reference ECO-related losses. Should a number of such bills arise, at the very least, a claims audit would be in order. In the extreme case, the reinsurer employing the claims executive should consider whether it would be profitable to do business with the cedent in the future.

b. Whose ‘Fraud’ are We Referencing?

Both our XPL and ECO clauses include “fraud” in the laundry list of actions on the part of the cedent which may well give rise to excess of policy limits or extra-contractual liabilities. Both our XPL and ECO clauses also contain a provision exempting the reinsurer(s) for any liability for fraud committed by director(s), corporate officer(s) or a combination of the same.

Why does this distinction between the two types of fraud exist? Simply put, both the XPL and ECO clauses evolved to provide financial protection for the cedent’s liabilities arising out of claims-related obligations. This is alleged or actual fraud occasioned by its claim adjuster’s or representative’s actions. ECO and XPL clauses do not purport to provide indemnification for the type of fraud alleged in a shareholder’s derivative suit. The potential for fraud or collusion committed by key officers and directors constitutes the risks covered by the cedent’s Directors and Officers policy, not by its reinsurance treaties.

With that said, as referenced in last quarter’s XPL article, the cedent’s Errors and Omissions policy may well provide coverage for the types of claim-related incidents that also fall within the ambit of the XPL or ECO clause’s coverage. Paragraph D of the ECO clause cited above makes clear that making a claim with respect to Errors and Omissions coverage, if applicable, would be the first avenue of recovery. Under the authority of this paragraph, any recovery from the Errors and Omissions carrier inures to the benefit of the treaty reinsurer providing ECO coverage. A similar paragraph inserted in an XPL clause would have the same effect.

c. ‘Equitable Proportions’

More common in direct market life treaties than direct market property/casualty treaties, the following wording is sometimes part of an ECO clause:

The Reinsurer is not liable for Extra-Contractual Obligations unless it is concurred in writing and in advance with the actions of the Company which ultimately led to the imposition of the Extra-Contractual Obligations. In such situations, the Company will share in Extra-Contractual Obligations, in equitable proportions,
Bad faith as a cause of action now exists in all U.S. jurisdictions, but likely originated as a separate and actionable tort against an insurer in California in the 1960’s.

but all factors being equal, the division of any such assessments would be in proportion to the total risk accepted by each party for [the plan] [the policy] of insurance involved.

The intent of such a clause is to support those actions of the cedent which may be risky in a plaintiff-oriented judicial forum, but are seen as being legally sufficient and practically appropriate to adjudicate the nature and extent of the cedent’s obligations under given policy(ies) of insurance. The drafter also wanted to afford a measure of control to the involved direct market reinsurer which wants to confine the moral hazard to those actions reasonably designed to track the intent of the insurance policy(ies).

Five problems exist, however, when the elements of the clause are put into effect with relation to a claim. First, the language anticipates that the reinsurer is not one of many in the brokered reinsurance market, but has both the financial weight and staff available to freely consult with the cedent. Second, the clause’s language fails to encompass those circumstances where the cedent’s claims professional’s actions produce a bad faith lawsuit, but neither that representative nor the reinsurer’s representative thought those actions were risky. Third, neither does the wording take into account those actions which are entered into under such time pressures that there is little real time in which to discuss them. Fourth, the “equitable proportions” language is so imprecise that it may lead to dissension between the cedent and reinsurer as to who owes what when the reinsurance bill is issued. And fifth, most importantly, the language may lead to a risk, in certain jurisdictions, of the reinsurer being deemed to be a co-agent or joint venturer with the cedent with respect to actions that the insured will later typify as “bad faith” in the event of very close time pressures. But the ECO clause provides financial recovery for those actions which are nowhere covered in any reinsured policy of insurance. The treaty wording “those liabilities not covered under any other provision of this Contract” underscores this concept. Mixing and matching is simply counter-indicated.

4. ABOUT WHAT SHOULD A REINSURANCE CLAIMS EXECUTIVE BE PARTICULARLY CAREFUL?

a Beware: Absence of ECO Clause in the Treaty

This precept was stressed in last quarter’s column, but it is so essential to the appropriate construction of a treaty that I bear repeating. Absent an ECO (or XPL) clause, any extra-contractual liabilities are not assumed by the reinsurer and remains with the cedent.7

Are there any exceptions to this principle? They are rare indeed. As mentioned, the reinsurer’s active participation in the handling of the original claim, if the circumstances are sufficiently extreme, may expose the cedent to extra-contractual liability. Also, if a fronting situation exists, and the reinsurer(s) behind the front participates in Claims-handling, it is possible that the reinsurer may be liable for ECO-type damages.8

b. Beware: Existence of Coverage other than Reinsurance Claim-Specific Coverage Under the Treaty

In a few words, Errors and Omissions Coverage. The situation is easy, where in the initial ECO clause cited above,

CONTINUED ON PAGE 12

5 See Section 5 infra. The term “plan” is typically used in a life reinsurance treaty to denote the specific types of policy-term, universal or whole-which are subject to the treaty.

6 The factual scenario from the older case of Peerless Ins. Co. v. Inland Mut. Ins. Co., 251 F. 2d 696 (4th Cir. 1958), where the reinsurer and insurer worked closely together on a claim, demonstrates the dangers involved. In that case, the reinsurer was found liable for damages under a joint enterprise theory with the cedent. (XPL rather than ECO).


all other recoveries under other insurance policies inure to the benefit of the reinsurer participating on the treaty containing the ECO clause. The situation is more difficult where the specific ECO clause omits this language. The prudent reinsurance claims executive then resorts to construing the remainder of the treaty. It would also be prudent to put the Errors and Omissions carrier on notice at the earliest possible juncture.

c. Beware: ECO Clauses Can Apply to Both Compensatory and Punitive Damages Awarded Against a Cedent

In a bad faith action by an insured, awards against a cedent can be either for compensatory damages or punitive damages. Compensatory damages are those awarded by the court to compensate an insured for the results of the cedent’s alleged or actual tortious conduct. Punitive damages, of course, are awarded to punish the cedent for its supposed reprehensible conduct.

In either the instance of the compensatory damages award or punitive damages award, financial recovery under the ECO clause may be proper so long as the awards arise out of the supposed tortious conduct of the cedent. So, for example, the insured’s necessary attorneys’ fees resulting from pursuing the bad faith lawsuit may be characterized as compensatory damages by the court. But, since this award results from the initial tortious conduct of the cedent, it is recoverable under the ECO clause. The careful cedent’s claims executive will read the judge’s opinion carefully to determine the origin of either compensatory or punitive damages before authorizing the issuance of an invoice including ECO losses.

d. Beware: What to Consider When Faced with a Punitive Damages Award in a Jurisdiction Which Prohibits Insurability of Such Damages?

Many reinsurance claims executives would agree that, when faced with a punitive damages award against a cedent in a jurisdiction that prohibits insurability of such damages, the better course is to omit such damages from the applicable reinsurance billing even where an ECO clause is contained in the treaty. It is worth noting however, that in such circumstances, at least one district court would disagree.

In Hartford Fire Ins. Co. vs. Lloyd’s Syndicate 00056 Ash, infra, the court upheld an arbitration ruling specifying that, where the relevant treaty contained an ECO clause, the reinsurers had to pay their billed amounts of punitive damages awarded against the cedent in California and Oklahoma. It was undisputed that Oklahoma and California prohibit insurance of punitive damages. Holding that the New York Convention5 denied it any discretion to refuse to confirm the arbitration award, the court noted that (a) there is no uniform federal law barring insurability of punitive damages and (b) the relevant treaty contained an “honorable engagement clause”, allowing the original arbitrators to “abstain from following strict rules of law”. The court held that the New York Convention, applicable to instances in which international reinsurers were involved, preempted state law in this instance.

How is the proactive reinsurance claims executive to reconcile this single case with any intent to exclude punitive damages where not insurable in a particular jurisdiction? Modifying the clause in the treaty-drafting phase to eliminate the “honorable engagement” wording is the extreme solution, perhaps proving more harmful when applied to situations other than simply ECO. A possible practical solution is for the reinsurer(s) to communicate such intent to the cedent in advance of actual claims submissions by means of a writing, and thereafter obtain the cedent’s consent.

e. Beware: Avoid Sticky Wickets in Coverage Calculation Where both XPL and ECO Clauses are Involved!

In last quarter’s XPL article, we discussed that, in the context of an excess of loss treaty, it is important to calculate ordinary “loss” and XPL “loss” separately. After all, in hard market conditions, many treaties specify that the cedent only recovers a percentage of XPL “loss”, while the entirety of ordinary “loss” is recoverable under the treaty. This concept becomes even more significant when the individual “loss” includes potential ECO recoveries. A separate and smaller percentage of recoveries often pertain to ECO “loss” as opposed to XPL “loss”. The smaller percentage takes into account the greater amount of co-insurance a reinsurer’s management may want in exchange for indemnifying its cedent for potential tortious acts.

In calculating the overall amount due from the cedent, we will assume the overwhelmingly usual scenario where one reinsurance occurrence is billed.10

The ordinary “loss” is billed at 100%, then, separately and at the different percentages, each of the XPL and ECO losses are added-up to treaty limits. How expenses are then calculated with respect to each of the proportional XPL and ECO recoveries is based on an analysis of the remainder of the treaty.

5. THAT OTHER REINSURANCE-ECO CLAUSES IN LIFE TREATIES

Let’s move briefly to that other reinsurance—that of life insurance policies. Life reinsurance treaties sometimes contain ECO clauses, although there is never an XPL clause. Unlike casualty treaties, life and health treaties provide indemnification of only first party insurance coverage. Therefore, there is never an obligation to a third party claimant. There exists no duty to defend or handle/settle an insured’s lawsuit appropriately. There remains, however, the duty to investigate and indemnify the claim occasioned by the death of the insured. And when a life insurer allegedly or actually

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10 Since XPL and ECO damages typically relate to one set of circumstances occasioning bad faith, this is a reasonable assumption.
falsely attributed to those duties appropriately, it is faced with extremely sympathetic plaintiffs—the insured’s beneficiaries; namely widows and orphans!

Because life reinsurance is sold by large, direct-market reinsurers with in-house staffs of sales professionals, the specific ECO clause is often tailored to the individual needs of the reinsurer and its cedent. The life insurance market is not plagued by the market cycles seen by the property/casualty industry. While the “equitable proportions” clause referenced above is often used, there are few real barriers to reconsidering that wording. The careful life reinsurance claims executive is urged to do so.

6. CONCLUSION

In the next issue of the Journal of Reinsurance, we will explore the permutations of the Commutations (“Sunset”) Clause. Until then, I wish you many favorable claims resolutions!

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