

Reinsurance

Revealing insights

Reinsurers increasingly make use of inspection clauses

For some time, the loss experience of a cedant of the reinsurance company Example Re gave rise to concern. The posted reserves were extraordinarily high. As this development was not understandable from the available information, the people in charge at Example Re decided to call for an inspection of records of the cedant, a direct insurer.

The contractual basis of such a measure is the inspection clause (access of records clause, *droit du regard*). This clause will typically be found in the last third of a reinsurance agreement, close to the arbitration clause, the determination of the place of jurisdiction and the applicable law clauses. It allows the reinsurer (cessionary) to take a look at the respective records of the reinsured (cedant) without indicating any particular reasons.

A typical inspection clause reads as follows:

„The reinsurer or its designated representatives shall have access at any reasonable time to all records of the company which pertain in any

way to this reinsurance” (source: Brokers and Reinsurance Markets Association).

Other more detailed inspection clauses may allow the reinsurer to take copies of documents. They may also point out that the right of inspection does not end with the cancellation of the contract, but takes on during the run-off period. The idea behind the right of inspection is clear and unambiguous: The cedant conducts its business independently from the reinsurer with the effect of automatically binding the reinsurer. Consequently the reinsurer needs a right to control the cedant's conduct in some way.

Until the early eighties, it was one of these clauses, always included in a reinsurance agreement, but never called, and therefore without practical relevance. If problems were arising from a reinsurance agreement, managers of both parties met and had a good meal to find a solution – nobody even dared to think about an inspection that might endanger the important business relationship.

The situation has since changed fundamentally, at least in Anglo-American reinsurance business. Under the influence of more complicated reinsurance policy wordings and complex major claims such as asbestos, a regular inspection practice has developed in the USA and lately also affected European reinsurance business.

Reasons for inspections vary

A reinsurer may consider calling an inspection for various reasons:

The routine inspection: Mainly for compliance reasons, executive boards of reinsurers have the cedant's records regularly inspected, usually by hired consultants. The idea is to eliminate general discomfort of the reinsurer due to its information deficit. Such routine practice mainly exists in the US, but is not yet common in continental Europe. Here the prevailing opinion is that the bilateral working contact between cedant and cessionary is the best way to eliminate information deficits.

The problem inspection: There may be various triggers for the problem inspection. In most cases it is triggered by the deterioration of a cedant's loss experience. The reinsurer uses the inspection to identify the reasons for the deterioration in order to find the adequate contractual adjustments for the future or to terminate the contract. Triggers may also be market rumors about irregularities in the way the cedant conducts its business. This may be different breaches of contract or market rules by the cedant, e.g. systematic inclusion of excluded risks or exceeding of contractual limits, irregularities in bookkeeping or systematically incorrect loss reserves or settlement. In continental Europe, the right of inspection includes insight into litigation files and

legal opinions of the cedant whereas such request may lead to rejection or dispute in the US.

The commutation motivated inspection: it is usually difficult for the re-insurer to evaluate the cedant's reserves (including IBNR - Incurred but Not Reported – reserves) and the appropriate commutation price when separating the current business from the business in run-off. An inspection can help the reinsurer to make better estimations.

Clarify rights and objectives in advance

Any consideration to perform an inspection needs to take account of the reinsurer's role, i.e. whether it is a sole reinsurer, a leading or co-reinsurer. In case of co-reinsurance, there might a number of complications which may not be regulated by the inspection clause. There are rarely leadership clauses which transfer the right of inspection entirely to the leading reinsurer and thus exclude the co-reinsurer from the right of inspection. The basic rule is that every co-reinsurer has its own right of inspection.

It is however not clear whether co-reinsurers may perform the inspection jointly sharing costs (or may exchange information) or whether this is forbidden by the confidentiality clause. Coinsurers may exclude these uncertainties by early agreements with each other and with the cedant. Though an individual co-reinsurer may exercise its right of inspection on its own, the co-reinsurer has to consider whether it is economically reasonable to pay 100 percent of the inspection costs for its possibly small share in risk and premium.

When planning an inspection it is important to clarify its objective: in particular, whether the

inspection is aimed at preserving a contractual relationship or aimed at gathering evidence for the necessary cancellation of an already disrupted relationship. If the reinsurer is interested in preserving the relationship an informal cooperation might be a better alternative than a formal inspection.

Before deciding on an inspection, the reinsurer should bear in mind that an inspection has confirmative effect. If the reinsurer does not find evidence of substantial deficiencies during an examination, he will later have problems to voice respective allegations again. It is therefore advisable to provide for sufficient quality of the inspection.

Especially reinsurers from the US should also consider that a request for an inspection at a European cedant may cause alienation between the parties. When deciding for or against an inspection, the reinsurer should always also consider the possible negative effects.

It makes sense to divide the inspection into three phases: preparation, implementation and follow up.

Preparation is of importance

In order to perform the inspection quickly and effectively, the reinsurer should prepare it carefully and – as far as possible – in cooperation with the cedant. The reinsurer should clarify which department is to be inspected (underwriting, accounting or claims) and which time frame should be regarded (e.g. the last twelve months).

Any preparation begins with the definition of what is to be examined in order to come to an adequate

preselection of files. It makes no sense to examine the totality of the cedant's files. Useful is an intelligent choice of only a few characteristic business processes. The reinsurer usually requests the cedant to send him an entire list of files from which the reinsurer then chooses samples. The reinsurer will of course have to consider that its investigators understand the language(s) of the files to be examined. The use of translators would be expensive and inadequate – they would probably not recognize the problematic particularities.

All questions of scheduling, rooms for the inspection, duration, right to take photocopies and printouts, access to EDP as well as confidentiality are to be discussed and agreed by the parties in advance, as openly and cooperatively as possible.

Such variety of issues should be approached with friendliness and a certain generosity as in the following example: a particular type of losses was to be examined and the professional qualification of the investigator was most important. Only his knowledge of the file language was weak and he would have needed excessive time to examine the documents in the foreign language. A compromise with the cedant could be reached: against the reinsurer's promise to limit the inspection to three of more than one hundred loss files, the cedant agreed to send these files to the reinsurer, in order to spare the investigator a longer stay abroad and at the same time to reduce the scope of inspection for the cedant. Inspections are made easier if the cedant designates a competent employee as contact person from the beginning who is always ready to answer to the investigator's questions.

In the US, cedants more and more often complicate the preparation of an inspection by requesting a supplementary confidentiality agreement as precondition for allowing the inspection. Such supplementary agreements often contain hidden clauses, such as:

- The reinsurer may not entice away personnel of the cedant.
- Copies allowedly taken during the inspection may not be removed from the examination room.
- Knowledge gained during the inspection and copies received may only be used by the reinsurer internally, thus not be used as evidence in court.
- For breaches of the confidentiality agreement, the reinsurer has to pay unlimited compensation and to accept American law and jurisdiction.

Such limitations of the contractual right of inspection of the reinsurer are abusive and unacceptable.

Perform the inspection cooperatively

Depending on the objectives and also on the honesty of the parties, there can be the friendly inspection or the inspection burdened by defensive measures.

A friendly inspection we recall started with a competent lawyer of the cedant telling the auditor during the initial conversation "off the record" that most complaints of the reinsurer were justified and that the cedant hoped to gain understanding of the reinsurer for its problematic situation and ultimately to work jointly towards an amicable solution. This friendly inspection led a few months

later to the commutation of the pool participation at a rounded figure.

In another case (as an example for a defense burdened inspection) most requested files were incomplete or were simply not submitted for inspection. During that inspection which took place in Florida in July, the cedant also had the air conditioning switched off in the examination room.

In the end, the inspection showed that the retrocedant was attempting to reach a commutation on the basis of 100% claims reserves plus 400 percent of IBNR, while trying to conceal the fact that he himself had just commuted this book of business with his cedant on the basis of 70 per cent of claims reserves including IBNR – an attempt to defraud the examining retro partner.

Inspections seldom lead to such extreme results. The usual inspection is uneventful. The auditors try to make sure that the cedant's work is orderly and honest and in conformity with the rules. This is usually the case. It has to be documented briefly and concisely with supporting documents.

If the auditors detect individual processing errors this has no further relevance as long as these errors do not indicate a system with impact on the results.

During the inspection it is important that the auditors keep their eyes open for completely unexpected things, as our experience shows: one examination dealt with losses in an extremely loss-affected portfolio. In one file, the auditors found a copy of the premium invoice to an insured, in the total amount of approximately EUR 100,000.00, split into premium EUR 50,000.00 and costs EUR 50,000.00.

It was obvious that the cedant had not incurred any substantial costs for the risk assessment, which is why the reinsurer contested the cost amount. It turned out that the cedant had systematically invented costs in order to share only half of the total premium with the reinsurer in breach of the reinsurance contract. In this case, all participating reinsurers received a reimbursement of premiums in proportion to the unjustified cost deduction.

Take appropriate action

Only in exceptional cases will an inspection lead to such serious complaints. In such cases, the reinsurer has to decide whether he wants to continue with the contract and try to remedy shortcomings of the cedant or if he wants to cancel the contract, even prematurely. But in most cases, an inspection will end without significant complaints.

Even if it is not explicitly stipulated in the inspection clause, a good and partnership-based approach requires the reinsurer to let the cedant have a copy of the full inspection report without delay after the end of the inspection. It is about the cedant's files, the examination took place in his house. He has a clear interest not only in the result, but also in the details and reasons.

It should also be self-evident in the context of a good partnership between cedant and reinsurer that the managers of both sides subsequently meet, discuss the findings of the auditors and coordinate remedial measures in case of relevant deficiencies.

By such proceeding, both parties can benefit from the inspection.

Please do not hesitate to contact us if you have any queries.



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