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CONTRACT FINALITY—WHAT A CONCEPT!

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The reinsurance industry is unique among business ventures for its history of handshake agreements and contract terms written on the backs of cocktail napkins.

In what other industry do businesses agree to deals without a signed, final contract document, which clearly states all the terms and conditions of the parties' agreement? Where in business do you ever see contracting parties begin to perform under a contract months and, historically, years before the final contract wording is executed? Welcome to reinsurance, where deals worth millions of dollars happen often with no more than minimal terms and conditions actually written down as agreed between the parties.

Historical Practice

In the London market, where reinsurance effectively began, the reinsured's broker visited underwriters individually and provided them with the basic details of the business to be reinsured. If the underwriter was interested, the underwriter would "scratch" or sign the broker's placement slip, which was nothing more than an outline of the basic terms and conditions of the reinsurance with a place for each reinsurance underwriter to indicate the level of participation the underwriter wished to assume (the "line"). The broker would go from underwriter to underwriter until the slip was completed (the full percentage participation sought by the reinsured was agreed to by various underwriters). Sometime later, the lead underwriter and the broker, on behalf of the reinsured, would agree to the final contract wording. In the meantime, premiums are paid, accounts are rendered, and losses are paid all before a final contract is actually signed by the parties. Sometimes the parties agree to end their relationship before the final contract wording is even agreed.

Remarkably, this system has persisted nearly unchanged into modern times. Even in markets outside London, including the United States, the practice of contracting via a slip—exchanged by fax or later by e-mail—instead of a final contract at inception is common practice. One can only suspect that this unique practice arose because of the special relationship between market participants and the reciprocal duty of utmost good faith. Or perhaps the speed by which certain insurance covers were needed, especially for marine or construction risks, required minimal evidence of coverage to be followed up by formal contract wording.

Even more remarkable is the historical lackadaisical attitude toward ever finalizing the contract wording by many in the reinsurance industry. While not common today, it was not so long ago that parties to a reinsurance contract would fail to finalize the contract wording even after years of dealings between each other as reinsured and reinsurer.

The Obvious Problem

It should be obvious to the casual observer of the "agree now and contract later" practice in the reinsurance industry that failing to agree to a complete and certain contract wording before performance begins will likely cause problems if a dispute arises. While the slip provides the basic terms and conditions of the reinsurance contract, the devil is in the

details. What does the phrase "arbitration clause" mean in a slip? What kind of arbitration? What are the qualifications of the arbitrators? How many arbitrators will decide the dispute? Or what does "ultimate net loss" mean without a full definition? Does it include allocated loss adjustment expenses or incurred but not reported losses? We can go on and on with brief headings of agreement and references to so-called standard clauses that beg for full elucidation.

A typical term in reinsurance slips is the phrase "to be agreed." This phrase may be used for many important terms of the contract, including the dispute resolution clause and many of the definitional clauses, not to mention the final wording ("final contract wording to be agreed by lead underwriter"). Of course, these "to be agreed" terms often are the basis for subsequent disputes between the parties.

For years now, parties to reinsurance contracts and their counsel have been fighting over the terms of slips after the parties' relationship has terminated without both parties having signed the final contract wording. What controls the relationship, the slip or the unsigned wording? When the reinsurance relationship breaks down, undefined terms, abbreviations and minimalist language provide fodder for disputes. While the parties may have thought they understood each other when the slip was signed, it often turns out that there was no clear agreement on the detail of the contract now in dispute. The failure to have a final and certain contract before the contract term begins means that the parties really have no idea what they truly agreed to in detail.

Evidence of the seriousness of this problem was highlighted by the failure to have a property insurance contract in place for the World Trade Center. While not a reinsurance problem, the placement of such a unique, layered property cover followed the traditional pattern of having the insurers agree via slips and temporary wordings before the final property insurance contracts were signed. As we all know, while the cover was "in place" on July 1, the terrorist attacks on September 11 occurred before there was universal agreement to the final contract wording. The failure of a certain and uniform definition of "occurrence" cost Mr. Silverstein hundreds of millions of dollars (so far).

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What Is Being Done About Contract Finality?

The problem of entering into an agreement before final contracts are signed has spurred various regulatory responses across the industry. On the financial front, the National Association of Insurance Commissioners adopted a rule requiring that final contract wordings be signed within nine months of the contract's effective date to allow for accounting treatment as prospective, as opposed to retroactive, reinsurance. Even with the nine-month rule, many reinsurance contracts are still not finalized in a timely manner. Moreover, the nine-month rule really only addresses an accounting issue and does not lead to contract finality and certainty at the time the contract goes into effect.

In the London Market, "contract certainty" is the latest buzzword. The London Market has drafted a Contract Certainty Code of Practice, which was created by its Market Reform Group. Under the Code of Practice, contract certainty must become a reality by December 31, 2006. What that means is that reinsurance contracts incepting January 1, 2007, in the London Market must be final and certain on the effective date of the contract.

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Essentially, the idea of contract certainty is that each party will know exactly what the product is that is being sold at the time it is being sold, so it can be priced correctly and so the purchaser knows exactly what he or she is buying without any later misunderstandings. Now, under Contract Certainty, terms "to be agreed" have to be agreed by the inception date of the reinsurance contract.

In the United States, contract finality or certainty has not yet been imposed to the level of the London Market Code of Practice for Contract Certainty. The nine-month rule, which really comes out of Part 23 of SSAP 62, requires that the reinsurance contract be finalized—reduced to written form and signed within nine months after commencement of the policy period—but allows the contract to incept before the contract is finalized. With the problems and lawsuits emanating from the World Trade Center, the call for contract finality at the inception date of contracting is growing louder.

Conclusion

Agreeing to terms and conditions of a business contract on the day of placement of the contract is only a foreign concept in the world of insurance and reinsurance. While contract finality on the date of inception will not eliminate disputes between the parties, it will go a long way toward reducing disputes arising out of "to be agreed" and other ambiguous or barely referenced contract terms. Moreover, just because there is no current regulatory requirement in the United States for a finalized contract at inception does not mean parties may not insist on a finalized wording at placement. Tell your reinsurance broker that you want the final contract wording agreed and signed no later than the effective date of your reinsurance contract. You never know, maybe you will be the first to have a final contract wording in place before the inception date of your contract. ✺

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