The Insolvency Wording and Related Contract Considerations in Canadian Reinsurance Agreements

Meeting the expectations of OSFI Guideline B-3

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PACICC's mission and principles

Mission Statement

The mission of the Property and Casualty Insurance Compensation Corporation is to protect eligible policyholders from undue financial loss in the event that a member insurer becomes insolvent. We work to minimize the costs of insurer insolvencies and seek to maintain a high level of consumer and business confidence in Canada's property and casualty insurance industry through the financial protection we provide to policyholders.

Principles

- *In the unlikely event that an insurance company becomes insolvent, policyholders should be protected from undue financial loss through prompt payment of covered claims.*
- *Financial preparedness is fundamental to PACICC's successful management support of insurance company liquidations, requiring both adequate financial capacity and prudently managed compensation funds.*
- *Good corporate governance, well-informed stakeholders and cost-effective delivery of member services are foundations for success.*
- *Frequent and open consultations with members, regulators, liquidators and other stakeholders will strengthen PACICC's performance.*
- *In-depth P&C insurance industry knowledge – based on applied research and analysis – is essential for effective monitoring of insolvency risk.*

CONTENTS

Executive Summary **1**

Summary of OSFI Guideline B-3 expectations **2**

The Insolvency Wording – Overview and Historic Perspective **4**

- Duty of Reinsurer to the Liquidator of an Insolvent Insurer 4
- Duty of Liquidator to Reinsurer 4
- Treatment of Offset in the Insolvency Wording 5
- Canadian Treatment Offset in the Insolvency Wording 5
- Other Common Features of the Insolvency Wording 6
- Insolvency of the Reinsurer 7
- When the "company" is a "group" of individual financial entities 7
- Treatment of Cut-through Endorsements 8

Related Wordings **9**

- Offset Wording 9
- Canadian Law 9
- Service of Suit 10
- Loss Reserve Funding 10
- Additional Contract Issues 11

Proposed Wording **12**

Additional Contract Wording Recommendations **16**

Appendix A – Service of Suit 17
Appendix B – Loss Reserve Funding 19

About the Author

David Wilmot is a semi-retired senior reinsurance executive with 40 years of underwriting and management experience. Throughout his career, David has directed considerable attention to drafting, editing and critiquing most of the Canadian treaty wordings, articles and clauses in current use.

Executive Summary

In PACICC's experience with insurance company liquidations over more than two decades, uncertainties have frequently arisen with respect to the recovery of reinsurance receivables post-insolvency. Reinsurance is typically the largest asset in the estate of an insolvent insurance company, and so reducing uncertainty regarding payment obligations is essential to the goal of protecting policyholders when an insurer fails.

Because current reinsurance practices vary with respect to insolvency wordings and related conditions, PACICC has commissioned research to support the development of an effective insolvency wording for use in Canadian reinsurance contracts that complies fully with the new requirements of OSFI Guideline B-3. The research has been conducted by David Wilmot, a former reinsurance company executive and acknowledged expert on treaty wordings.

Following industry consultation, OSFI Guideline B-3 – *Sound Reinsurance Practices and Procedures* – was issued in December 2010. All federally regulated insurers must address the principles contained within the guideline by July 1, 2011, and demonstrate full compliance by July 1, 2012. A key objective set out by Guideline B-3 is to ensure that reinsurance contracts avoid "terms or conditions that may limit a troubled or insolvent cedant's ability to enforce the contractual obligations of a reinsurer, or that may adversely affect the treatment of any claims in respect of the cedant's policyholders." The guideline further notes that "particular attention should be paid to 'insolvency clauses', 'off-set' or 'cut-through clauses', 'funds withheld arrangements', and other such types of terms and conditions."

PACICC strongly supports the actions taken by OSFI in Guideline B-3 to reduce the risk of insolvency, and to clarify the role of reinsurance in the unlikely event that an insurer becomes insolvent. It is important to ensure that reinsurance contracts do not give preferential treatment to certain creditors or policyholders through the use of offset, cut-through or other means that could be inconsistent with the requirements of the legislation governing the liquidation of insurance companies in Canada – the federal *Winding-Up and Restructuring Act*.

PACICC has developed an insolvency wording to comply, we believe, with OSFI's new guideline. PACICC's research also addresses other insolvency-related policy wordings for insurers to consider as they establish their reinsurance risk management policies.

Summary of OSFI Guideline B-3 Expectations

This report addresses reinsurance contract certainty with regard to policyholder and creditor protection in the event of insolvency on the part of a Federally Regulated Insurer (FRI). Under review are those reinsurance contract wordings and practices that may be influenced, altered or even negated by recent (2009-2010) changes to the reinsurance regime of the Office of the Superintendent of Financial Institutions (OSFI), and more specifically by OSFI Guideline B-3 – *Sound Reinsurance Practices and Procedures*.

OSFI's New Reinsurance Regime
In December of 2010, the OSFI issued Guideline B-3, *Sound Reinsurance Practices and Procedures*. Implementation is expected as soon as practically possible, with Board approval of a Reinsurance Risk Management Policy (filed with the OSFI Relationship Manager) by July 1, 2011, and full compliance, including initial declaration to the Board, by July 1, 2012.

OSFI's new reinsurance regime can be described as a regulatory and supervisory shift toward greater disclosure requirements and an increased regulatory scrutiny and supervision of reinsurance arrangements and reinsurance contracts.

Guideline B-3 should be read in its entirety, but the following is a brief overview of those sections of the guideline that pertain to the potential insolvency of a FRI. (Guideline titles and numbering applies.)

"Key Principles" – Each FRI will develop a prudent, principles-driven approach to managing reinsurance risks and develop a reinsurance risk management policy. OSFI will assess this policy against the Guideline principles, and may intervene and impose remedial action.

1. The FRI should implement and document a Reinsurance Risk Management Policy appropriate to the "scale, nature and complexity" of the FRI. The FRI's position regarding registered and unregistered reinsurance should be detailed, and the reinsurance program should be assessed (perhaps even stress-tested) against plausible loss scenarios. The Policy is subject to board oversight, senior management implementation, and timely review.
2. The FRI should evaluate the ability of all current and prospective reinsurers to, "meet their liabilities under exceptional but plausible adverse events," relying on its own due diligence and not simply that of third party brokers or rating agencies.
   Unregistered reinsurance calls for an even higher level of due diligence, and any assessment of such counterparties should consider the regulatory, legal and insolvency frameworks of the unregistered party's home jurisdiction.
3. "Contract certainty," or written documentation prior to the reinsurance contract's effective date, requires, at the very least, signed binders that include, "any standard clauses that are to be relied upon or incorporated by reference into the reinsurance contract."
4. The reinsurance agreement "should provide that funds will be available to cover policyholder claims in the event of either the cedant's or reinsurer's insolvency." The following contract terms are addressed specifically:

Insolvency wording
All reinsurance contracts should contain an insolvency wording that requires the reinsurer to continue making full payments without reduction due to the FRI's insolvency. The objective is "greater certainty that reinsurance receivables will remain within the overall general estate of the insolvent ceding company … rather than being allocated toward the payment of specific claims of creditors or policyholders."

"Offset" or "Cut-through" wordings
Particular attention should be paid to "off-set" and "cut-through" clauses. OSFI recognizes the utility of such arrangements, but will allow them only "where they do not give preferential treatment over claims under the distribution in the *Winding-Up and Restructuring Act*." OSFI makes it clear that "the reinsurer should not have any right of off-set against the obligations of [an insolvent foreign FRI] other than those related to [that] ceding company's insurance business in Canada."

Funds Withheld Arrangements
Any "funds withheld" arrangements must ensure continuous control by the FRI and result in such funds forming part of the FRI's general estate (or, in the case of a foreign FRI, forming part of the assets in Canada).

"other such types of terms and conditions"
Attention must also be paid to "other such types of terms and conditions that may frustrate the scheme of priorities under the *Winding-Up and Restructuring Act*."

Applicable Law and Service of Suit
Finally, OSFI expects all reinsurance contracts to "stipulate a choice of forum, a choice of law, and the appointment of agents for service of legal processes [such that] any disputes arising from such contract are subject to the laws and courts of a Canadian province" (or jurisdictional equivalent as defined by the Guideline).

Guideline Administration
The FRI is expected to promptly inform OSFI of reinsurance issues that could materially impact its financial condition. As a consequence of non-adherence to the principles of this Guideline**, "OSFI may not grant a capital/asset credit for the reinsurance arrangement or may … use its discretionary authority under the ICA, to adjust the FRI's capital/asset requirements or target solvency ratios ….**" (Emphasis added.)

The Insolvency Wording – Overview and Historic Perspective

There are very few examples of "standard" reinsurance wordings. Individual markets, individual reinsurers, individual brokers, and, to an increasing extent, individual insurers, favour one wording, section, turn of phrase or feature over all others. At best, this report can only identify certain common elements usually found in each of the wordings that make up a reinsurance agreement. The Insolvency wording is no exception. What follows is a broad overview, giving some historic perspective to each of this wording's common elements. All examples come from the wording repository of the Brokers and Reinsurance Markets Association (BRMA) unless otherwise indicated.

Duty of Reinsurer to the Liquidator of an Insolvent Insurer
A reinsurance agreement is a contract of indemnity. That is, the reinsurer is obliged to reimburse the insurer for amounts that the insurer has paid on claims that fall within the protection of the reinsurance agreement. However, an insolvent insurer, under the control of a liquidator or receiver, will often resolve claims by a process that includes the withholding of payment until all assets are determined and by the disbursement of available funds such that claims may be paid at less than 100 cents on the dollar. The purpose of the Insolvency wording is to secure from the reinsurer a contractual "exception" to the indemnity principle by which the reinsurer will meet its contractual obligations *in full* despite the fact that claims may not be paid immediately or in full by the liquidator of the now insolvent ceding company.

"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."

Thus, the liquidator need only show that a policyholder claim has been "accepted as valid" in order to require full and immediate payment from the reinsurer. Most insurance regulators expect this wording to appear in treaty contracts, and, in the absence of the wording, may disallow capital credit for the reinsurance purchased or, in the event of insolvency, deem the wording to be in place.

Duty of Liquidator to Reinsurer
The wording gives rights to the liquidator by putting the reinsurer in the position of paying claims "as if the insolvency had not occurred." However, the liquidator has assumed the role of the insurer in respect to certain duties owed to the reinsurer. Reinsurers have a right to expect timely advice of claims as well as access to files and even the right to participate in claim settlement.

These rights are of particular importance in the case of liquidation. Unlike the insurer, who had a vested interest in claims outcome and who saw the reinsurance relationship in terms of an ongoing partnership, the liquidator has different, and perhaps conflicting, objectives. Misunderstandings between liquidators and reinsurers have resulted in legal actions, and so these duties are often set out in an additional section to the Insolvency wording.

"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 or bond reinsured 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."

The company/liquidator has a duty to report claims in a timely fashion, and to allow time for the reinsurer to consider the information provided. Moreover, the liquidator must recognize the reinsurer's motivation, under the circumstances of liquidation, to assume a greater degree of involvement in the settlement of a potentially large loss. Cooperation must be given the reinsurer, and, to the extent that the reinsurer's settlement activities can be shown to mitigate the loss, the reinsurer's expenses are to be shared appropriately with the company in liquidation. Serious abuse of these responsibilities could result in a claim of bad faith against the company/liquidator.

Treatment of Offset in the Insolvency Wording

At any given time in an ongoing reinsurance relationship, there may be outstanding credits and debits between the contracting parties. It is common and accepted practice to offset such credits and balances so that one party remits only the net amount owed. Historically, it has been common practice to address offset in the Insolvency wording.

Older American example:

"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, 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."

Recent UK example:

"The Reinsurer shall be entitled (but not obliged) to set-off, against any sum which it may be liable to pay the Reinsured, any sum for which the Reinsured is liable to pay the Reinsurer."

In the past, offset was accepted in most jurisdictions. However, developing issues surrounding the practice are varied and complex, with the result that a growing number of regulators are applying restrictions on its use. The Canadian market situation deserves closer attention below.

Canadian Treatment of Offset in the Insolvency Wording

An offset section appears in almost all Canadian Insolvency wordings currently in use. However, a survey of model wordings suggests that there has been considerable latitude given to

reinsurers. The RRC recommended section is both broad and simple, inasmuch as it addresses the insolvency of either party to the agreement and imposes no limitations either within or beyond the scope of the contract.

"In the event of the insolvency of any party hereto, the Company or the Reinsurer may offset any balances, whether with respect to premiums, commissions, losses, loss expenses, salvages or any other amount, due from one party to other under this Agreement or any other reinsurance agreement heretofore or hereafter entered into between the Company and the Reinsurer."

A model section used by at least one intermediary expands the offset of balances to include not only incurred but not reported (IBNR) losses "in existence" at date of liquidation, but also any subsequent development (further IBNR) of unsettled claims.

"Any debits or credits, liquidated or unliquidated in favour of or against either party on the date of entry of the receivership or liquidation order, are deemed mutual debits or credits, as the case may be, and shall be set off and the balance only shall be allowed or paid. Although such claim, if any, on the part of either party against the other may be unliquidated or undetermined in amount on the date of the entry of the receivership or liquidation order, such claim, if any, is hereby deemed to be in existence as of such date and any credits or claims then in existence and held by the other party may be offset against it."

Such wordings predate an important Canadian court decision, Canada (Attorney General) v. Reliance Insurance Co. (2008), C.C.L.I. (4th) 220, 40 C.B.R. (5th) 292, 165 A.C.W.S. (3d) 66, [2008] O.J. No. 795, 2008 CarswellOnt 1118 (S.C.J.), which now articulates the severe limitations imposed on offset in the event of liquidation. The *Winding-up and Restructuring Act*, Section 73, limits "set-off" to any "debts due or accruing due." The court affirms that "debts due and accruing due" means, in essence, that only those *quantifiable* amounts at date of liquidation, such as claims settled but not yet paid or premiums due but not yet remitted, may be set off against one another. Outstanding losses, IBNRs, and certainly, all future loss development must be treated as *contingent* amounts at date of insolvency, and therefore disallowed for set-off purposes.

In passing, it should be noted that rights of offset may be set out not simply by the offset section of the Insolvency wording, but by the terms of any Offset wording included elsewhere in the contract.

Other Common Features of the Insolvency Wording

From an historic perspective, the above elements have been included in most Canadian Insolvency wordings for more than three decades. All can be found in the current recommended Insolvency wording published by the RRC in 1991. One additional section has been a constant in most Canadian contracts – a section that addresses the sharing of costs when multiple reinsurers participate in the settlement of a claim. Here is the RRC model:

"Where two or more Reinsurers are involved in the same claim and a majority interest elect to interpose defence to such a claim the expense shall be apportioned in accordance with the terms of this Agreement as though such expense had been incurred by the Company."

Other features have appeared in various Canadian and foreign wordings.

Insolvency of the Reinsurer
An increasing number of Canadian wordings contain a section dealing with the insolvency of the reinsurer. Once optional, such a section is now necessary in order to meet OSFI expectations. The section will be of value to the company, but also to the liquidator in the case of an insolvent company.

Several issues may be addressed. An insolvent-reinsurer section, which invariably follows the cedant-insolvency-offset section, will address offset in this reversed circumstance. Key to this section is the withholding of funds by the ceding company until the resolution of all liabilities. The example below is widely used by at least one Canadian reinsurance intermediary.

"In the event of the insolvency of the Reinsurer, all amounts due but not paid to the Reinsurer by the Company on such date under this Agreement and any other reinsurance agreement, regardless of the date on which they became due, and all amounts which become due to the Reinsurer by the Company after that date under this Agreement and any other reinsurance agreement may be retained by the Company and set off against the amounts due by the Reinsurer under this Agreement and any other reinsurance agreement, whether they were due before the insolvency or became due after. The balance only, if any, shall be payable by the Company to the Reinsurer at the expiry of all liability under this Agreement and any other reinsurance agreement."

When the "Company" is a "group" of individual financial entities
OSFI makes a distinction between federally and non-federally regulated members of a group of insurance companies, reinsured as a group, if a member company not under OSFI supervision becomes insolvent. Under such circumstances, OSFI expects the group company and its reinsurers to "crystallize" the liabilities of the group member not under OSFI supervision, and disconnect reinsurance obligations to/of the insolvent member from those of the remaining group. Thus, reinsurance offsets between the solvent and insolvent group members would be disallowed. When OSFI sought contract clarity on this requirement, the Canadian market experimented with a number of wording solutions, including changes to the treaty preamble. Today, a broader and more generic solution addresses the OSFI requirement in the opening statement of the insolvency wording itself. The following model is used by the Canadian reinsurance intermediary noted above, and by others.

"If more than one Reinsured is included in the preamble to this Contract within the description 'Reinsured', this Article shall apply separately to each insolvent Reinsured. The insolvency of one Reinsured within the definition of "Reinsured" shall not affect the terms of this Contract as they apply to the other companies within the definition of 'Reinsured'."

Another intermediary suggests a model of this section in which the intent is expressed in greater detail.

"In the event of the insolvency of any individual cedant included in the term 'Company', each party to this Contract agrees to honor the terms set forth herein as if the Contract were a separate Contract between the Reinsurer and each individual cedant. Balances payable to or recoverable by the Reinsurer or each individual cedant shall not serve to offset any balances payable to or recoverable from any other cedant under this Contract. However, nothing contained herein shall increase the limit(s) of the Reinsurer or the retention of the Company as provided in the Cover Article nor the premiums payable by the Company as provided in the Premium and Rates Article."

Treatment of Cut-through Endorsements

Historically, some foreign insolvency wordings have included a provision for what may broadly be described as "cut-through agreements" or "guarantee endorsements." Such agreements commit the reinsurer to pay losses (or the reinsured portion of losses) *directly* to a particular insured, promptly and in full, if the insurer becomes insolvent. Thus, the cut-through endorsement gives preferential treatment to certain named creditors in liquidation over all others. There are relatively few instances of cut-through endorsements in Canada, but because of historic use elsewhere, and because of the reference to cut-through agreements in OSFI Guideline B-3, a model (BRMA) is included here for illustrative purposes.

"It is further understood and agreed that, in the event of the insolvency of the Company, the reinsurance under this Contract shall be payable directly by the Reinsurer to the Company or to its liquidator, receiver, conservator, or statutory successor, except ... (a) where this Contract specifically provides another payee of such reinsurance in the event of the insolvency of the Company and (b) where the Reinsurer with the consent of the direct insured or insureds has assumed such policy obligations of the Company as direct obligations of the Reinsurer to the payees under such policies and in substitution for the obligations of the Company to such payees."

As noted above, reinsurance cut-through agreements are not common to Canada, and for this reason, PACICC has not attempted to address them in its proposed wording. In fact, OSFI's guideline does not disallow cut-through agreements but insists that they not afford preferential treatment over other claims under the scheme of distribution in the *Winding-up and Restructuring Act.*

Related Wordings

All parts of the reinsurance contract must operate as an integrated whole. In addition to the Insolvency wording, other wordings or sections of wordings in Canadian reinsurance agreements are likely to be influenced by OSFI Guideline B-3.

Offset Wording
Many Canadian reinsurance contracts contain an offset agreement. Here is a generic example in its broadest form, encompassing all reinsurance dealings between the parties without limitation as to time or (presumably) jurisdiction.

"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."

Many wordings will limit applicable offsets to something less than the above model. For example, when business is placed through an intermediary, the broker may impose an obligation that limits offset to transactions through that intermediary. More restrictive still is the limitation of offsets to balances "under this Agreement." However restrictive, such models have been accepted by the Canadian reinsurance community.

Very often, the offset wording will contain reference to the Insolvency wording. Here is a model Offset wording in wide Canadian use.

"The Company and the Reinsurer, each at its option, may offset any balance or balances, whether on account of premiums, claims and losses, loss expenses or salvages due from one party to the other under this Contract, provided however that, in the event of the insolvency of a party hereto, offsets shall only be allowed in accordance with the insolvency clause and applicable statutes and regulations."

As in the case of cut-through agreements, OSFI recognizes the utility of off-set and does not intend to restrict its use where doing so will not give preferential treatment over other claims under the scheme of distribution in the *Winding-up and Restructuring Act*. PACICC notes that this recognizes that the utility and permissible use of offset in the case of a going concern differs from that of a winding-up situation.

Canadian Law Wording
Variously named "Governing Law," "Applicable Law," "Law and Jurisdiction," or, in Canada, "Canadian Law," this wording is a contractual provision designating which jurisdiction will govern disputes arising out of the reinsurance agreement. The wording may be as simple as:

This Contract shall be governed by and construed in accordance with the laws of Ontario, Canada.

However, a somewhat more robust wording will reduce the possibility of confusion, correct any conflict with the jurisdiction of the Arbitration article, and address issues of contract validity.

Here is a common Canadian Law and Jurisdiction wording followed by an often-used section addressing the Agreement's continuing application despite a legally invalid provision.

"Except as provided for by the Arbitration Article, the validity, construction and performance of this Agreement shall be interpreted by the laws of the province in which the Canadian head office of the Company is located and the federal laws of Canada applicable therein, and the Courts of such province shall have the sole jurisdiction in any dispute hereunder."

"If any provisions of this Agreement should be invalid under applicable laws, the latter shall control but only to the extent of the conflict without affecting the remaining provisions of this Agreement."

Note that this example correctly refers to provincial jurisdiction. Under the Canadian constitution, the provinces have exclusive power to deal with property and civil rights (which includes dealing with contracts) and the federal government has the exclusive jurisdiction to deal with bankruptcy and insolvency. When an insurance company becomes insolvent, it is put into liquidation under a federal statute - the *Winding-up and Restructuring Act*. However, the liquidation is supervised by a provincial (not a federal) court because the subject matter of the liquidation involves property and civil rights (including contractual rights).

Service of Suit Wording

Most Canadian reinsurance contracts include a Service of Suit wording, invariably attached to the contract as an appendix. Applying to non-registered reinsurers only, this wording is a contractual commitment on the part of the reinsurer to "submit to the jurisdiction of any Court of competent jurisdiction within Canada and [to] comply with all requirements necessary to give such Court jurisdiction and all matters arising hereunder shall be determined in accordance with the law and practice of such Court."

A fairly standard version of this wording can be found in Appendix A.

Loss Reserve Funding Wording

If one or more of the FRI's reinsurers cannot be accepted for loss reserve credit by Canadian regulatory authorities (the most common example being an unlicensed reinsurer), the treaty will normally include a Loss Reserve Funding wording, either as a treaty article or as an Appendix. Thus, reinsurers subject to the wording agree to meet the cedant's capital requirements through some form of pledged assets.

A typical (but now out of date) Loss Reserve Funding wording is included as Appendix B for illustrative purposes. Note that this sample wording predates the OSFI Guideline, *Guidance for Reinsurance Security Agreements*, issued late in December of 2010.

Those wishing to arrange unlicensed reinsurance after June 30th, 2011, or to renew such reinsurance after June 30th 2012, may wish to adopt a redrafted Loss Reserve Funding wording (however named) that reflects both the *Guidance for Reinsurance Security Agreements* and Guideline B-3. The latter will require that pledged assets not be subject to offsets and that any withdrawals will take place without diminution due to the insolvency of either party.

Additional Contract Issues
In Guideline B-3, OSFI has attempted to identify and address those points of reinsurance conflict that have historically hampered effective liquidation of an insolvent FRI. However, liquidators of Canadian insurance companies have reported additional concerns.

Foreign Ownership of the FRI and Part XIII of the Insurance Act:
Whether the FRI is a subsidiary or branch of the foreign insurer, certain jurisdictional policy and coverage issues tend to arise out of liquidation. Most common are foreign-liquidator attempts to access Canadian assets by arguing that certain losses belong to the Canadian entity (often regardless of the location of the risk or where the risk was underwritten). Part XIII of the Canadian Insurance Act attempts to clarify financial responsibility for cross-border liabilities, and it is hoped and expected that FRI adherence to Part XIII will reduce if not entirely eliminate this problem.

International FRI with Common Account Reinsurance Protection:
If the FRI is a foreign subsidiary or branch, or if the FRI owns a foreign subsidiary or branch, reinsurance problems may arise if catastrophe, casualty clash, or other reinsurance has been purchased for the common account protection of the entire organization.

One potential problem is reinstatement premiums, payable following insolvency (perhaps even *because* of an event that led to insolvency). As an example, a Canadian loss, paid by a treaty priced to cover California earthquake, could impose a reinstatement premium grossly out of proportion to the resources of the relatively small Canadian operation.

Of greater concern are group reinsurance contracts with limited reinstatements or provisions that change, reduce or even eliminate coverage after one or more losses to the treaty. Multiple loss scenarios, complicated by geography, date of loss, timing of settlement, or any number of other factors (all relatively easy to untangle or absorb by an ongoing concern), may, in multi-jurisdictional liquidation, lead to the sort of legal conflict OSFI had hoped could be avoided.

Proposed Wording

PACICC has developed an Insolvency wording that attempts to draw on the best of Canadian model wordings currently in use while addressing multiple new demands:

- The newest regulatory expectations outlined in OSFI Guideline B-3,
- A precedent-setting court interpretation of the *Winding-up and Restructuring Act*, and
- A growing recognition of the complexities of offset law and the technical challenge of achieving clarity of intent within this challenging area of the law.

The need for clarity and certainty has prevailed over the appeal of brevity. However, it is expected that this recommended wording will help insurers to execute their Reinsurance Risk Management Policy.

INSOLVENCY
For the purposes of this Article - Insolvency: (i) the term "Company" shall mean each separate legal entity reinsured under this Agreement; (ii) the Canadian branch of a "foreign company", as such term is defined in the *Insurance Companies Act* (Canada) (as the same may be amended, restated or re-enacted from time to time) (the "Insurance Companies Act"), shall be considered to be a separate legal entity; (iii) each foreign branch of a "company", as such term is defined in the Insurance Companies Act, shall be considered to be a separate legal entity; and (iv) the term "this Agreement" shall include any predecessor reinsurance agreements that have been continuously renewed by this Agreement.

This Article shall apply separately to each Company reinsured under this Agreement. The provisions of this Article shall apply notwithstanding any other provision in this Agreement or in any other agreement between the Company and the Reinsurer. Notwithstanding the foregoing, nothing in this Article – Insolvency shall increase the Reinsurer's liability pursuant to the reinsuring agreement contained in this Agreement, even though more than one Company may be reinsured by the Agreement.

In the event of the insolvency of the Company, reinsurance under this Agreement shall be payable by the Reinsurer directly to the Company, or to its liquidator, receiver, or statutory successor, on the basis of the liability of the Company under the policy or policies reinsured without diminution because of the insolvency of the Company.

The Company, or its liquidator, receiver or statutory successor, shall give written notice to the Reinsurer of the pendency of any claim against the Company on any policy reinsured which might affect this Agreement within a reasonable time after such claim is filed in the insolvency proceedings. The Reinsurer may investigate and/or defend any such claim in the place of the Company. The expense thus incurred by the Reinsurer shall be chargeable, subject to court approval, against the Company as part of the expense of liquidation to the extent of the proportionate share of the benefit which may accrue to the Company solely as a result of the defence undertaken by the Reinsurer.

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

In the event of the insolvency of the Company, the Reinsurer shall be entitled to set off any debts due or accruing due to the Company under this Agreement at the commencement of the winding-up of the Company against any debts due or accruing due to the Reinsurer by the Company under this Agreement at the commencement of the winding-up of the Company. For greater certainty, it is understood and agreed that the Reinsurer shall not be entitled for any reason whatsoever to: (i) exercise any set off rights (whether by operation of law, equity, agreement or otherwise) other than as set forth in the previous sentence; or (ii) set off (whether by operation of law, equity, agreement or otherwise) any debts due or accruing due to the Company under this Agreement against any debts due or accruing due to the Reinsurer by any other Company reinsured under this Agreement or any other agreement between the Reinsurer and any such Company.

In the event of the insolvency of the Reinsurer, all amounts due but not paid to the Reinsurer by the Company on such date under this Agreement and any other reinsurance agreement, regardless of the date on which they became due, and all amounts which become due to the Reinsurer by the Company after that date under this Agreement and any other reinsurance agreement may be retained by the Company and set off against the amounts due by the Reinsurer under this Agreement and any other reinsurance agreement, whether they were due before the insolvency or became due after. The balance only, if any, shall be payable by the Company to the Reinsurer at the expiry of all liability under this Agreement and any other reinsurance agreement.

Notwithstanding any other provision in this Agreement, in the event of the insolvency of any Company that is subject to the *Winding-up and Restructuring Act* (Canada); (i) this Agreement will be governed by and interpreted under the laws of the province in which the Canadian head office of such Company is located, or if the Company is a "foreign company", as such term is defined in the *Insurance Companies Act*, the province of Canada in which its Chief Agent is ordinarily resident, and the laws of Canada applicable therein, regardless of the laws that might otherwise govern under applicable principles of conflicts of laws; (ii) all parties to this Agreement hereby irrevocably attorn to the non-exclusive jurisdiction of the courts of such province and the courts competent to hear appeals therefrom with respect to any matter arising under or related to this Agreement; (iii) all disputes with respect to any matter arising under or related to this Article – Insolvency including, without limitation, its enforceability, application or interpretation shall be determined exclusively by the court of such province and the courts competent to hear appeals therefrom, and not by arbitration; and (iv) the parties to this Agreement that are not governed by the *Insurance Companies Act* or any equivalent legislation enacted by any province or territory of Canada each hereby irrevocably appoints the Superintendent of Financial Institutions as agent for service of process with respect to any matter arising under or related to this Agreement.

***Notes regarding the Insolvency wording*:**

(i) The first section defines members of a reinsured group of companies as single entities for the purposes of this Insolvency wording. The section also separates those divisions of a company that will, in liquidation, fall under separate regulatory authority. Although the Canadian Branch of a foreign company is not a separate legal entity, this wording contracts that, in liquidation, the FRI *is* a separate entity.

Though likely to apply only to Canadian Life insurers, the possibility of a foreign branch or branches has also been addressed.

(ii) A new section separates each such company, in the event of insolvency, for purposes such as offset. The section also ensures that the altered requirements of this Article do not represent a conflict in the Agreement, nor do they increase the reinsurer's obligations under the Agreement.

(iii) The third section is the key and mandatory reinsurer waiver of indemnification.

(iv) Duties of the liquidator are outlined in this fourth section.
Note that the Reinsurer, at its option, may participate in the claim settlement process, and to the extent such participation benefits the Company in liquidation, recover some of its costs. This section, already in wide Canadian use, recognizes the heightened role of the Reinsurer, in respect to potentially large losses, once the Company/Reinsurer relationship has ended.

(v) Unrecoverable reinsurer claim costs, if any, will be shared among all reinsurers in proportion to their respective treaty participations (had the majority agreed to claim participation).

(vi) The offset section has undergone considerable change, not only to meet new regulatory expectations, but also to address complexities in the laws of offset, to reflect the terminology of the *Winding-Up and Restructuring Act* and, in particular, to recognize the limitations imposed on offset as recognized in a recent Canadian court interpretation of that terminology.
Any reference to "applicable law" (which, in the case of offset, will include common law) has been removed inasmuch as this wording attempts to impose contact law.
Debits and credits have been limited to sums due under "this Agreement." This approach is already in wide use, and avoids many of the complications associated with multiple contracts and multiple participants over an extended period of time.
However, it should be noted that, in Section 1 above, continuously renewed contracts fall within the meaning of "this Agreement."
A statement "for greater certainty" has been added to establish more clearly (and confirm as contractual) that offset shall not apply across the separate (notwithstanding mutually-reinsured) companies defined in section (i) above.

(vii) The seventh section deals with the insolvency of a reinsurer and the contracted right of the Company to hold back amounts due the reinsurer (under this and other contracts) until the expiry of all liability. No changes have been made to this widely used wording, and it will be noted that offset guidelines are not consistent with those of the section above. However, if the reinsurer is domestic, then Canadian rules will apply. If foreign, then liquidation will be governed by the laws of the reinsurer's incorporation – a jurisdiction where the laws regarding offset may be broader or perhaps narrower.

(viii) An entirely new section has been suggested for use as a "failsafe" intended to ensure that the OSFI requirements of governing law, jurisdiction and service of suit have been met by the reinsurance contract. In particular, PACICC suggests the inclusion of its wording together with this section if the FRI finds itself to be a "participant" in an international reinsurance agreement that is otherwise devoid of Canadian law or service of suit provisions. An "Insolvency-Canada" Article would

afford the FRI continued reinsurance credit without unduly imposing Canadian regulatory demands upon the entire treaty.

The section also stipulates that any disputes arising out of *this Insolvency wording* will be resolved by provincial court and not by arbitration. Law pertaining to the *Winding-up and Restructuring Act* is not the domain of arbitration, and certainly not in the domain of an arbitration that could, through the operation of the arbitration wording, convene in a foreign country.

Additional Contract Wording Recommendations

In addition to adoption of the recommended Insolvency wording, it is suggested that the entire reinsurance contract be assessed in terms of Guideline B-3 compliance. Adopting such a procedure as part of the Reinsurance Risk Management Policy will not only contribute to overall sound risk management practices, but will also help to ensure statutory capital recognition of all reinsurances in place. Below, PACICC has identified a few wording considerations that deserve particular attention.

Offset wording
If the contract contains a provision for offset, PACICC recommends the use of a model Offset wording that recognizes and, in the event of liquidation, defers to the Insolvency wording.

Canadian Law wording
PACICC notes the OSFI expectation that a suitable wording will ensure that the laws of Canada will apply to matters relating to the reinsurance contract. PACICC suggests the use of a model wording sufficiently robust as to avoid common areas of possible confusion or jurisdictional disagreement.

Service of Suit wording
PACICC notes the OSFI expectation that a suitable wording will contract non-registered reinsurers, if any, to accept actions in Canada.

Loss Reserve Funding wording
When required, Loss Reserve Funding wordings should clarify that funds are not subject to the provisions of any offset agreements and that withdrawals are not reduced by the insolvency of either party.

Binders
PACICC notes the OSFI expectation that binders, should they be necessary, will provide the same level of contract certainty as a final wording with regard to maters raised by Guideline B-3. PACICC recommends that such binders *include* those wordings identified by this report as appropriate or, at the very least, *reference* such wordings in a manner that ensures certainty as to the wording model contracted.

Cut-through agreements
PACICC notes the OSFI expectation that so-called cut-through agreements or similar arrangements will be avoided should they violate the statutory order of priority under the *Winding-up and Restructuring Act*. PACICC recommends that any and all contracts that front for or identify an ultimate insured party be carefully edited of commitments non-compliant with Guideline B-3, resulting in the contract not being permissible for capital treatment.

Group or Whole-Company Reinsurance
PACICC suggests that the Reinsurance Risk Management Policy will benefit from a thorough examination/analysis of potential loss-recovery and reinstatement issues if the reinsurance agreement names or includes the FRI as only one of the entities under its protection.

Appendix A – Service of Suit

(Applies only to Canada and certain Insurance Companies (London))

A. This Article applies only to Reinsurers not registered to do business in Canada under the Insurance Companies Act. This Article is not intended to conflict with or override the parties' obligation to arbitrate their disputes in accordance with [the Arbitration Article]

B. In the event of the failure of the Reinsurers hereon, or any of them, to pay any amount claimed to be due hereunder, the Reinsurers hereon, at the request of the Company, will submit to the jurisdiction of any Court of competent jurisdiction within Canada and will comply with all requirements necessary to give such Court jurisdiction and all matters arising hereunder shall be determined in accordance with the law and practice of such Court.

C. (i) *Canada:*

Service of process in such suit may be made upon [Name and address of Canadian legal firm], and in any suit instituted against any one of them upon this Agreement, the Reinsurers will abide by the final decision of such Court or of any Appellate Court in the event of an appeal.

(ii) *Certain Insurance Companies (London):*

Service of process in such suit may be made upon [Name and address of Canadian legal firm], and in any suit instituted against any one of the Companies, and such designation shall be binding upon the Companies liable hereunder as if they had each been individually named as Defendant upon this Agreement, the Reinsurers will abide by the final decision of such court or of any Appellate Court in the event of an appeal.

D. The Reinsurers hereon hereby authorizes [name of legal firm] to receive on its behalf service of process in any such suit and instructs them to notify the Reinsurers forthwith after service. Upon notice, the Reinsurers so served shall promptly give instructions enabling [name of legal firm] to cause to be entered on behalf of such Reinsurers in Ontario or other Canadian jurisdiction a general appearance or notice of intention to defend or document having similar effect.

E. The Reinsurers hereby agrees to indemnify [name of legal firm] for all reasonable legal fees incurred in notifying or attempting to notify the Reinsurers of service of process and causing to be entered a general appearance or notice of intention to defend on behalf of Reinsurers.

F. Pursuant to any statute of any province, territory or district of Canada which makes provision therefore, the Reinsurers hereon hereby designates the Superintendent of Financial Institutions or the Superintendent, the Commissioner or Director of Insurance

or other officer specified for that purpose in the statute, or the successor or successors in office, as their 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 Agreement, and hereby designate the above named [name of legal firm] as the firm to whom the said officer is authorized to mail such process or a true copy thereof.

(Applies only to Lloyd's Underwriters)

G. In any action to enforce the obligations of the Underwriters liable hereunder they can be designated or named as "Lloyd's Underwriters" and such designation shall be binding on the Underwriters liable hereunder as if they had each been individually named as Defendant. Service of such proceedings may validly be made upon the Attorney In Fact in Canada for Lloyd's Underwriters, whose address for such service is 1155, rue Metcalfe, Suite 2220, Montreal, Quebec H3B 2V6.

Appendix B – Loss Reserve Funding

LOSS RESERVE FUNDING

A. As respects business subject to Canadian regulation:
   (This section applies only to those Reinsurers whose participation in this Contract is not accepted for loss reserve credit by Canadian insurance authorities having jurisdiction over the Company.)
   1. The Company agrees, in respect of its Policies or bonds falling within the scope of this Contract, that when it files with Canadian insurance authorities or sets up on its books reserves for outstanding losses, it shall forward to the Reinsurer a statement showing the Reinsurer's portion of such loss reserves.
   2. "Loss reserves" as used herein shall also include Loss Adjustment Expenses.
   3. The Reinsurer agrees, if requested to do so by the Company, that it shall set up, on behalf of the Company, a deposit for its share of the known losses outstanding, including Loss Adjustment Expenses and incurred but not reported loss and Loss Adjustment Expense relating to any known Loss Occurrence, in a manner that provides a full and complete credit against any required minimum asset test, minimum capital test or its equivalent, in one or the other (or apportioned between both) of the following forms, as specified by the Company:
      a. By transmittal to the Company of an Outstanding Cash Advance (OCA) which the Company agrees to receive in trust for the Reinsurer and to either:
         i. deposit such funds in an interest-bearing account opened with a depository acceptable to Canadian insurance authorities; and/or
         ii. to arrange investment of such funds in similarly approved Government of Canada (or Provincial Government) short-term securities.
      b. By applying for and securing delivery to the Company of a clean, irrevocable Letter of Credit (LOC) to be issued by a Canadian chartered bank in a form acceptable to Canadian insurance authorities. The LOC shall be issued for a period of not less than one year, and shall be subject to automatic renewal for a further one year period.
   4. The Company undertakes to use and apply any amounts realized on such securities or which it may withdraw from such OCA account and/or which it may draw against such LOC (pursuant to the terms of the contract under which the LOC is held) for the following purposes only:
      a. To pay the Reinsurer's share or to reimburse the Company for the Reinsurer's share of any liability for loss reinsured by this Contract.
      b. To make refund of any sum which is in excess of the actual amount required to pay the Reinsurer's share of any liability reinsured by this Contract.
      c. In respect of OCA funds or securities only, to credit to its own account, or to the Reinsurer, the net interest earned on such funds or securities, as specified below.
   5. The Company agrees to credit the Reinsurer with 80% of the actual interest earned on OCA funds or securities less "NON RESIDENT WITHHOLDING TAX", as required by Canadian law, and shall be entitled to deduct the 20% balance of said interest as an annual fee for the administration and handling of such funds or securities.
   6. The Company further agrees to prepare and submit to the Reinsurer, as soon as practicable after the 30th September, a statement showing the current status of the

LOC and/or OCA account. The Company also shall advise the Reinsurer, as soon as practicable after the 30th September the amount owing to the Reinsurer (being any refunds plus interest earned) or the amount owed by the Reinsurer to the Company in respect of the reserve funds advanced at the preceding 31st December. Any balances due shall be forwarded by the debtor party by the 31st December of that year.

7. The bank issuing such LOC, or chosen as depository of such OCA funds shall have no responsibility whatsoever in connection with the propriety of amounts drawn or withdrawals made by the Company, nor as to the disposition of funds so drawn or withdrawn, except to see that credit drawn or withdrawals made are effected only upon the order of properly authorized representatives of the Company.

B. As respects business subject to United States regulation:
(This section applies only to the extent a Reinsurer does not qualify for credit with any insurance regulatory authority having jurisdiction over the Company's reserves.)

1. The Company agrees, in respect of its Policies or bonds falling within the scope of this Contract, that when it files with its insurance regulatory authority, or sets up on its books liabilities as required by law, it shall forward to the Reinsurer a statement showing the proportion of such liabilities applicable to the Reinsurer. The "Reinsurer's Obligations" shall be defined as follows:
    a. known outstanding losses that have been reported to the Reinsurer and Loss Adjustment Expense relating thereto;
    b. losses and Loss Adjustment Expense paid by the Company but not recovered from the Reinsurer;
    c. incurred but not reported loss and Loss Adjustment Expense relating to any known Loss Occurrence;
    d. all other amounts for which the Company cannot take credit on its financial statements unless funding is provided by the Reinsurer.
2. The Reinsurer's Obligations shall be funded by funds withheld, cash advances, Trust Agreement or LOC. 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.
3. When funding by an LOC, the Reinsurer agrees to apply for and secure timely delivery to the Company of a clean, irrevocable and unconditional LOC 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 Obligations. Such LOC 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 30 days (or such other time period as may be 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 LOC extended for any additional period.
4. The Reinsurer and the Company agree that any funding 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 that has not been otherwise paid;
b. to make refund of any sum that is in excess of the actual amount required to pay the Reinsurer's Obligations under this Contract (or in excess of 102% of the Reinsurer's Obligations, if funding is provided by a Trust Agreement);
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. Any taxes payable on accrued interest shall be paid out of the assets in the account that are in excess of the Reinsurer's Obligations (or in excess of 102% of the Reinsurer's Obligations, if funding is provided by a Trust Agreement). If the assets are inadequate to pay taxes, any taxes due shall be paid by the Reinsurer;
d. to pay the Reinsurer's share of any other amounts the Company claims are due under this Contract.

5. If the amount drawn by the Company is in excess of the actual amount required for B.4.a., c. or d., the Company shall promptly return to the Reinsurer the excess amount so drawn. All of the foregoing shall be applied without diminution because of insolvency on the part of the Company or the Reinsurer.
6. The issuing bank shall have no responsibility whatsoever in connection with the propriety of withdrawals made by the Company or the disposition of funds withdrawn, except to ensure that withdrawals are made only upon the order of properly authorized representatives of the Company.
7. At annual intervals, or more frequently at the discretion of the Company, but never more frequently than quarterly, the Company shall prepare a specific statement of the Reinsurer's Obligations for the sole purpose of amending the LOC or other method of funding, in the following manner:
   a. If the statement shows that the Reinsurer's Obligations exceed the balance of the LOC as of the statement date, the Reinsurer shall, within 30 days after receipt of the statement, secure delivery to the Company of an amendment to the LOC increasing the amount of credit by the amount of such difference. Should another method of funding be used, the Reinsurer shall, within the time period outlined above, increase such funding by the amount of such difference.
   b. If, however, the statement shows that the Reinsurer's Obligations are less than the balance of the LOC (or that 102% of the Reinsurer's Obligations are less than the trust account balance if funding is provided by a Trust Agreement), as of the statement date, the Company shall, within 30 days after receipt of written request from the Reinsurer, release such excess credit by agreeing to secure an amendment to the LOC reducing the amount of credit available by the amount of such excess credit. Should another method of funding be used, the Company shall, within the time period outlined above, decrease such funding by the amount of such excess.