

REINSURANCE: THE E&O RISKS WITH FRONTING ARRANGEMENTS

1. Introduction

Reinsurance brokers frequently place reinsurance for fronting insurers. The original insured may, due to local regulations, have to obtain cover written by a local fronting insurer. The fronting insurer, who will often be based in a foreign jurisdiction, issues a local policy (“the original policy”) to the original insured. It then reinsures the risk and, usually, retains only a small percentage of the risk.

The benefits of these fronting arrangements are that (i) the fronting insurer can offload all, or most of, the risk onto reinsurers, (ii) the original insured has cover that complies with local regulations and (iii) the original insured knows its risk is backed by reinsurers who, in many instances, will be more financially secure than the fronting insurer.

In this bulletin, we look at some of the E&O risks faced by brokers in these fronting arrangements.

2. Who is the broker’s client?

Is it the original insured, the fronting insurer or both? It is important for the broker to establish, at the outset, who it is acting for.

Whilst a reinsurance broker acts for the fronting insurer (on the placement of the reinsurance) there is a risk it may also unintentionally assume a responsibility to act for the original insured. This is especially so if the broker has direct contact with the original insured: the more regular that direct contact is the more likely it is the broker will be found, by a Court, to be acting for the original insured.

Once a broker has assumed a duty to act for both the fronting insurer and the original insured it is likely to be responsible for advising on (i) the placement of the reinsurance and (ii) the placement of the original policy. This may give rise to an E&O exposure if, for example, the broker has not properly assessed whether the original policy meets the needs of the original insured. This can be easily overlooked if the broker’s main focus is on the reinsurance placement.

If the broker does not want to assume a duty to act for the original insured, it should avoid any direct contact with the original insured. If that it is not possible, any direct contact should be kept to a minimum and the broker should confirm to the original insured, in writing, that (i) it does not act for it and (ii) is not advising it on the adequacy of the original policy terms.

Alternatively, if the broker is prepared to act for the original insured it should agree written terms of business that clearly set out the scope of the services it will be providing. This should minimise the risk of an E&O claim due to a misunderstanding about who the broker is acting for.

3. Conflicts of Interest

When a broker acts for both the original insured and the fronting insurer it will need to consider how potential conflicts of interest are handled.

The interests of both these clients will not always be the same so there is potential for a conflict. For example, when acting for the original insured the broker may need to negotiate against the fronting insurer to obtain wider coverage terms. This may conflict with duties owed to the fronting insurer on the placement of the reinsurance. Conflicts may also arise on claims (see **“5. Claims Notification”** below).

A broker can manage any potential conflicts by having two separate broking teams representing each client. A Chinese wall can be established between these teams to protect client confidentiality.

4. Does the reinsurance wording mirror the local policy wording on a “back-to-back” basis?

There may be an E&O exposure for the broker if the reinsurance policy does not provide “back-to-back” cover that mirrors the original policy terms. If the fronting insurer finds it has a significant unreinsured loss due to the reinsurance wording not operating on a fully “back-to-back” basis it may bring an E&O claim against its broker.

Under English law, using the words *“as original”* in a reinsurance policy may not be enough to establish that the reinsurance will be fully “back-to-back.” We highlight below some of the main areas a broker should consider if it is instructed to obtain “back-to-back” reinsurance cover.

a) **Does the law and jurisdiction stated in the reinsurance match that used in the original policy?**

The application of different laws, to policies with essentially the same wordings, can leave a fronting insurer with a gap in its reinsurance cover. For example, if the original policy is subject to Dutch law a condition precedent is unlikely to be strictly enforced. However, if the reinsurance is subject to English law, a condition precedent in the reinsurance wording is more likely to be strictly enforced. The result could be that the fronting insurer has to pay the claim under the original policy but it cannot make a recovery on its reinsurance. The fronting insurer may then claim its broker was negligent for not ensuring the same law and jurisdiction applied to both the reinsurance and the original policy.

To minimise this risk a broker should (i) ensure the law and jurisdiction in both the reinsurance and the original policy are the same, or (ii) advise the fronting insurer of a potential gap in its reinsurance cover if a different law and jurisdiction applies to the reinsurance contract.

b) Are any other reinsurance policy terms inconsistent with the terms in the original policy?

There is also a risk of an E&O claim from the fronting insurer if other reinsurance terms are inconsistent with the original policy: for example, if the original policy covers business interruption losses but the reinsurance wording specifically excludes them.

To manage this risk, a broker should carefully review both the original policy and the reinsurance policy to see if there are any material differences between the scope of cover provided by each. If there is potential for an unreinsured shortfall due to such differences, then the fronting insurer should be advised of this. The fronting insurer can then confirm whether it is content to proceed with the reinsurance placement or whether it would prefer to explore the possibility of obtaining wider reinsurance cover.

Sometimes, the broker will not be provided with a copy of the original policy when arranging the reinsurance. In such cases the broker should make it clear, to the fronting insurer, that (i) it has not seen the original policy wording and (ii) as a consequence, it cannot advise on whether there are material differences in the protection provided by the reinsurance and the cover given in the original policy.

5. Claims Notification

If a broker only acts for the fronting insurer on the placement of the reinsurance, then, as a general rule, it will only need to consider compliance with the claims notification provisions in the reinsurance contract.

However, where a broker has a dual role (ie it acts for both the original insured and the fronting insurer) it will need to consider compliance with the claims notification provisions in both (i) the reinsurance policy and (ii) the original policy. There is a risk of an E&O claim against the broker if the fronting insurer declines a claim due to breach of a notification requirement in the original policy. Brokers should be alert to this risk because it can be easy to overlook the notification requirements in the original policy if the broker's focus is mainly on the reinsurance.

For example, if a broker only notifies reinsurers of a loss in accordance with the reinsurance terms it may miss a crucial notification requirement in the original policy (ie a condition precedent requiring notification to the fronting insurer within 14 days of a loss – under English law it is not necessary for an insurer to show it has suffered prejudice due to such a breach). The reinsurer and the fronting insurer may then decline the claim due to non-compliance with the original policy. The original insured may then claim the broker is liable for negligently failing to notify the fronting insurer in accordance with the original policy terms.

The handling of claims is another example of how a broker is exposed if it does not clearly identify (i) who its clients are and (ii) what obligations it has to each client. Where the broker acts for both the fronting insurer and the original insured consideration

should be given to separate broking teams acting for each client. For example, there will be a conflict if the broker acts for a fronting insurer that wishes to reject a claim and it also acts for the original insured that wants to argue the claim is covered.

Separate broking teams acting for each client addresses potential conflicts of interest. It also minimises the risk of the broker overlooking what needs to be done to protect each clients' interests on the notification and handling of claims.

6. Cut - through clauses

The aim of a cut-through clause is to allow the original insured to recover losses directly from the reinsurer, by making the reinsurer directly liable to the original insured.

If a broker acts for the original insured, it might be criticised if it does not advise on the inclusion of a cut-through clause in the reinsurance policy. For example, if a fronting insurer becomes insolvent, then the original insured may have substantial uninsured losses if it has no right to pursue a direct action against the reinsurer. If the fronting insurer has a poor credit rating, the original insured may argue the broker was negligent if it did not advise it on the inclusion of a cut through clause in the reinsurance wording.

The enforceability of cut-through clauses is not always straightforward as the original insured is not a party to the reinsurance contract. Therefore, such clauses need to be carefully drafted. This is particularly so if the contract is subject to a foreign law. Even if English law applies, care still needs to be taken to, for example, not exclude the provisions of the Contracts (Rights of Third Parties) Act 1999: excluding this Act could prevent the original insured from enforcing a cut through clause because it is not a contracting party to the reinsurance.

As the drafting of cut-through clauses may not always be straightforward, a broker should consider, particularly in unusual or difficult cases, whether to recommend the client obtains legal advice on enforceability.

SUMMARY

The risk management message can be summarised as follows:

1. Be clear on who your client is. Is it the original insured, the fronting insurer or both? If you have any direct contact with the original insured then there is a risk a Court will find you do act for it.
2. Agree written TOBA's with all your clients so you, and they, understand your role and the scope of the services you are providing.
3. There is a potential conflict of interest if you act for both the original insured and the fronting insurer. Given this, consider having separate broking teams advising each client, with those teams divided by a Chinese wall.

4. Ensure, where possible, that the law and jurisdiction stated in the reinsurance wording matches that used in the original policy. If this cannot be done, advise the fronting insurer that different laws apply which means there could be a gap in its reinsurance cover.
5. Ask for a copy of the original policy and review it against the reinsurance wording to see if there are any material differences in the cover provided by each. The fronting insurer should be advised if there are material differences that could expose it to unreinsured losses.
6. If you have not seen the original policy wording, advise the fronting insurer there may be material differences between it and the reinsurance policy which could lead to unreinsured losses.
7. When acting for both the original insured and the fronting insurer ensure you have taken any necessary steps to comply with (i) claim notification provisions in the original policy and (ii) claim notification provisions in the reinsurance wording.
8. If you act for the original insured when arranging a fronting programme, consider whether to recommend a cut-through clause in the reinsurance wording. Also consider whether to recommend the client obtains legal advice on the enforceability of a cut-through clause.

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