THIRD PARTY BENEFICIARY: BINDING NONSIGNATORIES TO ARBITRATION CLAUSES IN REINSURANCE CONTRACTS

By

Robert M. Hall

[*Mr. Hall is a former law firm partner, a former insurance and reinsurance company executive and acts as an insurance consultant as well as an arbitrator and mediator of insurance disputes.* *Questions or comments may be addressed to Mr. Hall at bob@robertmhall.com.*]

I. Introduction

Given that arbitration is a creature of contract, it is easy to posit that a party that has not signed a contract with an arbitration clause has no right or obligation to arbitrate pursuant to that contract. However, there are several exceptions to this rule, one being third party beneficiary. The purpose of this article is to explore the implications of recent case law finding that an insured is the third party beneficiary of a reinsurance contract.

II. Third Party Beneficiary Rule

There is considerable case law to the effect that an arbitration clause in a contract may be applied in favor of or against a third party beneficiary of that contract.[1] One court has stated the test for third party beneficiary status as follows:

> [T]o qualify as a third party beneficiary of a contract, (a) the contracting parties must have intended that the third party beneficiary benefit from the contract, (b) the benefit must have been intended as a gift or in satisfaction of a pre-existing obligation of that person, and (c) the intent to benefit the third party must be a material part of the parties' purpose in entering into the contract. . . . Thus, if it was not the promisee's intention to confer direct benefits upon a third party, but rather such third party happens to benefit from the performance of the promise either coincidentally or indirectly, then the third party will have no enforceable rights under the contract.[2]

III. Recent Reinsurance Case Law on Point

Doeff v. Transatlantic Reins. Co., 2007 U.S. Dist. Lexis 91879 (E.D. PA) involved a claim against Jan Doeff under a Legion Insurance Company professional liability policy which was reinsured by Transatlantic. Subsequent to Legion withdrawing its defense of Doeff, a verdict was entered against him on a professional liability claim. When Legion was placed in receivership, Doeff sued Transatlantic directly and Transatlantic moved to compel arbitration under the arbitration clause in the reinsurance contract between Legion and Transatlantic. Doeff opposed the motion on the basis that he was not a signatory to the reinsurance contract and that the parties to such contract never intended that he submit to arbitration.

The court found that Doeff was a third party beneficiary of the reinsurance contract and that he was required to submit to arbitration pursuant to such contract. The court ruled that Doeff's status as a third party beneficiary had been determined by *Koken v. Legion Ins. Co.*, 831 A.2d 1198, 1234 (Com.Ct. PA. 2003). (See §V, *infra*, for an examination of *Koken* and its impact on the scope of this rule on reinsurance arbitrations).

IV. Non-Reinsurance Case Law on Point

Spear, Leeds & Kellog v. Central Life Assurance Co. et al., 85 F.3d 21 (2nd Cir.1996) involved a registered futures commission merchant and member of the New York Stock Exchange that opened several accounts and sub-accounts for Goodman, a commodities trader. Goodman purchased life insurance for the benefit of his clients so that in the event of his death, his clients would not have to await probate to collect funds due. When Goodman died, the insurers found that Goodman used false information to obtain the insurance and alleged that Spear, Leeds was complicit in this scheme. The insurers sought to arbitrate their claim against Spear, Leeds pursuant to the New York Stock Exchange Rules and Constitution.

The court observed that the Exchange Constitution and Arbitration Rules required that any dispute between a member and a non-member of the Exchange be arbitrated. The court held that the insurers were third party beneficiaries of such rules and could enforce the arbitration requirement.[3] The Second Circuit later reached a similar result under the arbitration rules of the National Association of Securities Dealers.[4]

This rule has been recognized in other cases despite the fact that it was not applicable in those cases. *E.I. DuPont De Nemours and Co. v. Rhone Poulenc et al.*, 269 F.3d 187 (3rd Cir.2001) and *Guardian Construction Co. et al. v. Tetra Tech Richardson*, 583 A.2d 1378 (Sup.Ct. Del 1990) (plaintiff not a third party beneficiary); *Industrial Electronic Corp. v. IPower Distribution Group*, 215 F.3d 677 (7th Cir. 2000) (no arbitration clause); *John F. Dodds, Jr. et al v. Pulte Home Corp. et al.*, 909 A.2d 348 (Sup.Ct.Pa. 2006) (substantial identity between a signatory and a non-signatory made use of third party beneficiary principles unnecessary).

V. *Koken v. Legion* and the Third Party Beneficiary Rule

As noted above, the court's *Doeff* ruling is based on that of the Pennsylvania Commonweath Court in *Koken v. Legion Ins. Co.*, 831 A.2d 1196 (Com.Ct.Pa.2002). Among other things, this case addressed the issue of the insureds of the insolvent insurer, Legion Insurance Company, seeking to go around the receiver of Legion and maintain a direct action against reinsurers. There is a long history of such direct actions and much has been written on the subject to the effect that insureds are not third party beneficiaries of reinsurance contracts.[5]

However, the *Koken* court found that the extreme fronting arrangements utilized by Legion and its reinsurers justified third party beneficiary status for insureds. The court found that Legion did not perform any due diligence or underwrite the risks. Legion did not bear any underwriting risk, handle any claims or any fund losses. That was done by reinsurers.[6] In addition, proceeds of the reinsurance contracts were not used by Legion for its general business purposes but "were used exclusively and entirely for the payment of Policyholder Intervenor claims."[7]

In essence, the court found pure fronting *i.e.* renting the use of insurance policies with no involvement in the underwriting, claims handling and risk retention that forms the essence of insurance. Under these circumstances, the true relationship was between the insureds and the reinsurers. From a business standpoint, the possibility of this legal result under these extreme circumstances has been well understood for at least 30 years and it is surprising that Legion and its reinsurers constructed the programs in this fashion.

From a precedential standpoint, however, the fact situation in *Koken* is so extreme as to limit severely the impact of the ruling of the *Doeff* court. Not only are the factual circumstances of the fronting arrangement very extreme, the Koken court found that the insureds on very program involved in *Doeff* to be third party beneficiaries.

VI. Conclusion

Case law allows a third party beneficiary on a contract with an arbitration clause to arbitrate disputes under such contract. In general, insureds are not third party beneficiaries of a reinsurance contract. However, the extreme fronting arrangements cited by the court in *Koken v. Legion* led the court to disregard the general rule and the same programs were at issue in *Doeff*. Therefore, *Doeff* can be read as giving preclusive effect to the same issue decided under those same facts by the Pennsylvania court rather than a broader statement of the law on reinsurance arbtiations.

ENDNOTES

[1] *See e.g. John Hancock Life Ins. Co. v. Wilson*, 254 F.3d 48, 59-61 (2nd Cir. 2001); *Spear, Leeds & Kellogg v. Central Life Assurance Co.*, 85 F.3d 21, 29-30 (2nd Cir. 1996); *Coastal Steel Corp. v. Tilghman Wheelabrator Ltd.*, 709 F.2d 190, 202-4 (3rd Cir. 1983), (overruled on other grounds).

[2] *DuPont De Nemours and Co. v. Rhone Poulenc Fiber and Resin Intermediaries et al.*, 269 F.3d 187, 196 (3rd Cir. 2001) (internal citations omitted).

[3] 85 F.3d at 26.

[4] *John Hancock Life Ins. Co. et al. v. Joseph A. Wilson et al.*, 254 F.3d 2001 (2nd Cir.2001).

[5] *See* Robert M. Hall, *Direct Actions and Setoff: The Next Generation*, VIII Mealey's Reins. Rpt. No. 7 at 15 (19970; T. Darrington Semple Jr. and Robert M. Hall, *The Receiver's Liability in the Event of the Insolvency of a Ceding Property and Casualty Insurer*, 21 Tort & Ins. L.J. 407 (1986)..

[6] 831 A. 2d at 1238.

[7] *Id. at 1237.*