**Extreme Fronting Arrangements and**

**Their Impact on Arbitration Rights**

**By**

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## I. Introduction

The insurance industry does (or should) understand well the dangers of extreme fronting arrangements *i.e.* when a reinsurer controls the underwriting and claims handling of the primary company, assuming all or a great majority of the underwriting risk. Regulators question whether the reinsurer is actually engaging in the business of insurance in their states and may inquire whether or not they are properly licensed to do so. Guaranty fund assessments, premium taxes and similar costs of doing a primary business may be assessed. Perhaps more important is the danger that reinsurers will subject themselves to Unfair Insurance Practices and similar statutes and regulations and direct actions against them by insureds and claimants.[1] The same lessons seem to be offered repeatedly.

The latest installment in the fronting lesson plan involves the arbitration clauses in reinsurance contracts used in fronting transactions. Can the reinsurer compel arbitration of claims that come from unusual angles *e.g.* not from the cedent? The purpose of this article is to examine recent caselaw relating to a claim by an insured against a fronting reinsurer and a relatively standard reinsurance arbitration clause.

## II. Claim by Insured Against Reinsurer in a Fronting Transaction

### A. Structure of the Fronting Transaction

The insured in *Leonberger v. United Sch. Ins. Council*, 2016 Mo. App. LEXIS 521 was a school district that had obtained $2,500,000 in liability insurance from a municipal captive insurance company that obtained $2,000,000 excess of $500,000 in coverage pursuant to facultative reinsurance from a risk retention group acting a reinsurer. The facultative agreement allowed the reinsurer to: (1) be associated with the cedent in the defense of claims; (2) approve defense counsel; and (3) take over the defense and settlement of claims. The reinsurer agreed not to settle any claims without the agreement of the cedent but if the cedent declined a settlement agreed to by the claimant and reinsurer, then the reinsurer's liability was limited to that represented by the proposed settlement amount.[2] The facultative contract contained the following arbitration clause:

> If any dispute should arise between the Reinsured and the Reinsurer with reference to the interpretation of this Agreement, or their rights with respect to any transaction involved . . . such dispute, upon the written request of either party shall be submitted to [an arbitration panel.][3]

B. Nature of the Claim

The claim arose when a school bus driver struck and killed a student. When a claim for liability was made, both the insurer and reinsurer hired their own counsel. Criminal charges were filed against the driver who ultimately pled guilty to avoid a jail sentence. When a wrongful death action was filed against the insured, counsel for reinsurer became heavily involved. It appears that the insurers denied the claim due to the criminal nature of the loss. The family of the deceased student obtained a judgment against the bus driver who brought an action against the insurer and reinsurer for bad faith failure to defend and settle and breach of fiduciary duty. The reinsurer moved to arbitrate the bus driver's claim pursuant to the arbitration clause in the facultative contract but that motion was denied.

C. Rulings by the Court

Initially, the appellate court ruled that the facultative contract was insurance, not reinsurance and that the insured was a third-party beneficiary of it:

> In an insurance agreement, an insurance company directly insures the holder of the policy issued by the company. In a reinsurance agreement, an insurance company is indemnified by another insurance company for all or parts of losses suffered by the

> former insurance company under the contracts of direct insurance it has issued to its policyholders. . . .
> . . . .
> The [facultative] contract does not, by its own terms, merely become liable upon [the insurer's] loss. Rather, its terms plainly insert [the reinsurer] into and declare its control over the claims asserted against [the insurer's] insureds.[4]
> . . . .
> This result leads to [the reinsurer's] third-party liability directly to . . . the original insured . . . [who] is a third-party beneficiary of the [facultative] contract and thus can maintain an action on the contract.[5]

Next, the court addressed the impact of § 435:350 of the Missouri Arbitration Act that prohibits arbitration clauses in insurance policies:

> A written agreement to submit any existing controversy to arbitration or a provision in a written contract, except contacts of insurance and contracts of adhesion, to submit to arbitration any controversy thereafter arising between the parties is valid, enforceable and irrevocable . . . .[6]

Given the it's finding that the facultative contract was insurance rather than reinsurance, the court ruled that this statute prohibited arbitration and nothing in the Liability Risk Retention Act pre-empted this Missouri statute.

The court went on to consider the reinsurer's claim that third-party beneficiary claims by insureds were within the scope of the arbitration clause because they were not excluded. The court ruled that the plain language of the arbitration clause limited it to disputes between the reinsurer and the insurer and that:

> [J]ust because the arbitration clause does not explicitly exclude third-party claims against [the insurer] or [reinsurer] does not mean they are implicitly included within the scope of the arbitration clause as [the reinsurer] asserts.[7]

## II. Conclusion

Fronting transactions have inherent business and regulatory perils. These are increased when a reinsurer takes control over claims through direct management of the claim-handling process without considering the impact on the arbitration clause, thereby undermining the reinsurer's arbitration rights. Apparently these are the sorts of lessons that must be repeated periodically in the marketplace.

## ENDNOTES

[1] *See Fronting: Business Considerations, Regulatory Concerns, Legislative Reactions and Related Caselaw* and *Fronting and Direct Action Against Reinsurers: The Final Chapter*, both are available at the author's website: robertmhall.com.

[2] Such provisions are common in professional liability insurance policies but appear very seldom in reinsurance contracts.

[3] 2016 Mo. App. LEXIS 521 *11 - 12.

[4] *Id.* at *16 – 17.

[5] *Id.* at *20.

[6] *Id.* at *14 – 15.

[7] *Id.* at *25.