FRONTING AND DIRECT ACTIONS AGAINST REINSURERS:

THE FINAL CHAPTER

By

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I. Introduction

In general, fronting is the process by which a primary insurer cedes all or virtually all of the insurance risk of loss to a reinsurer who controls the underwriting and/or claim handling process either directly or through a managing general agency or underwriter. Experienced insurance executives know that fronting carries with it significant business, regulatory and solvency concerns.[1] It has been on and off the regulators' radar screen for at least fifty years.[2] One of the concerns with fronting is that an insured will be allowed to bring a direct action against reinsurers in the event that the policy-issuing company becomes insolvent.[3] The purpose of this article is to examine recent case law which suggests a line of demarcation between normal reinsurance (where an insured has no right to collect directly from the reinsurer) and extreme fronting (where the reinsurer functionally acts as the insurer and can be sued directly by the insured).

II. Recent Case Law

Koken v. Legion Ins. Co., 831 A.2d 1196 (Com.Ct.Pa. 2002) was a seminal case examining, among other things, the rights of insureds with respect to reinsurers in an extreme fronting context. The court examined a variety of programs in which the insured was seeking third party beneficiary status with respect to the reinsurers. The facts of the Pulte Homes program were summarized by the court as follows:

> Since 1991, Pulte has provided for its general liability claims through a program of its own design that involves: (1) direct negotiation and purchase of reinsurance for Pulte's sole benefit; (2) a licensed fronting, or pass-through, insurance company to issue certificates of insurance so that Pulte could satisfy financial responsibility requirements; and 3) the handling [of] all liability claims by a third-party administrator (TPA) chosen

> and compensated by Pulte. The reinsurance companies bear the entire risk of any losses in excess of the Pulte self-insured retention, up to the limits of liability, and the fronting company bears none.[4]

The court found that despite a different twist, the Psychiatrists' Purchasing Group program was similar:

> Legion retained some risk; however, the amount of that risk was fully funded by the Program. For example, in 1988, Legion retained risk for $ 8.5 million in claims; for that risk, it received $ 8.5 million reduced to present value. This is not true underwriting risk where the policyholder pays a premium calculated by actuaries to pay expected, but uncertain losses. The pre-funding by [Psychiatrists'' Purchasing Group] rendered Legion's retention risk-free.[5]

The court made similar factual finding on other programs and summarized them as follows:

> . . . Legion Group's insureds were policyholders in name only; in effect, they were self-insureds that used Legion and Villanova as the means of obtaining stop-loss coverage from a reinsurer. Because Legion and Villanova did not function as true insurers, their underwriting and claims departments were minimally staffed; typically, claims were handled by a third-party administrator that was engaged and paid by the insured. Legion and Villanova did not place the reinsurance or negotiate its terms; . . .[6]

In evaluating these facts, the court articulated the rule for third party beneficiary status in Pennsylvania stated in *Guy v. Liederbach,* 459 A.2d 744 (Pa. 1983). The court found that insureds met this rule:

> First, it was the intention of the parties that the reinsurer assume all underwriting risk. Legion's only role was that of a fronting company, and the parties did not intend that Legion use the proceeds of the reinsurance for its general business purposes. Further, the reinsurance proceeds were used exclusively and entirely for the payment of Policyholder Intervenor claims, which satisfies the second part of the *Guy* test. Payment by the reinsurer companies was through Legion but for the benefit of the Policyholder Intervenors. In short, each "reinsurer" functioned as the direct insurer for each of the Policyholder Intervenors.
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> . . . . Here . . . factors are present to support a finding that the Policyholder Intervenors were third-party beneficiaries of the reinsurance contracts between Legion and the appropriate reinsurer. Legion acted as a fronting company, and it bore no true underwriting risk. Legion did not underwrite the risk, but, rather, was content to allow the true risk bearer, the reinsurer, to conduct the necessary due diligence. Legion also did not participate in the claims handling process, or the funding of claims. In all cases, these were the responsibility of the reinsurers.[7]

Stated more succinctly, the insureds were third party beneficiaries of the reinsurance contract because the ceding company had no meaningful involvement in underwriting the business or handling claims and incurred no insurance risk in the programs at issue.

A case which clarifies the relevant line of demarcation is *Ario v. Swiss Reins. Amer. Corp.*, 2007 Pa. Commw. Lexis 737 (Com. Ct.Pa.). In this case, the Chicago Tribune sought to insure its previously self-insured and future workers compensation exposure. The outstanding losses were transferred pursuant to a Loss Portfolio Transfer ("LPT") to Reliance Insurance Company in consideration of a sum which represented the present value of the reserves transferred. Reliance, in turn, transferred approximately 84% of this sum to Swiss Re. The reinsurance provided by Swiss Re was for 100% of Reliance's exposure but was limited by some aggregate caps which proved irrelevant since Tribune had traditional excess insurance to cover such aggregate caps. Although Reliance entered into a claims service agreement with a TPA, Swiss Re funded the accounts that were used to pay losses.[8]

The Gross Compensation Program ("GCO") transferred Tribune's ongoing workers compensation exposure to Reliance, subject to certain overall aggregate limits, for a three year period. In consideration of a large majority of the premium, Swiss Re reinsured 100% of Reliance's exposure except for certain "interim and aggregate caps" (not fully explained in the opinion) which Swiss Re declined to reinsure. While Reliance entered into a claims service agreement with a TPA, Swiss Re was directly responsible for payment of all claims.[9]

The court stated that the following factors were to be used in determining whether the insured should have direct access to the reinsurance:

- Did the insurer take on any underwriting risk or merely act as a front?
- Did the insurer enter into the transaction to generate fees rather than premium income?
- Did the "reinsurer" function as a "direct insurer" and did the reinsurer control the claims handling and funding process?
- Did the policyholder facilitate the reinsurer's involvement?
- Did the equities favor the policyholder's direct access to reinsurance?[10]

With respect to the LPT, the court upheld the ruling of the referee that Tribune should have direct access to reinsurance applying the standards above. The purpose of the transaction was simply to pass through liability to Swiss Re, Reliance retained no insurance risk and Swiss Re was responsible for claims. In addition, the equities favored Tribune.[11]

With respect to the GCP, the court also upheld the ruling of the referee that Tribune should not have direct access to reinsurance. The court drew two factual distinctions from the LPT. First, losses and loss payments were in the future thereby lending much more uncertainty to the amount that would ultimately become due. Second, "the GCP transaction was not structured as an up-front arrangement as Reliance retained underwriting risk, *i.e.*, was exposed to liability, since Swiss Re failed to insure Reliance's liability over the aggregate limits."[12] Therefore the equities were not with Tribune.

III. Commentary

Fronting is a practice that is known to carry with it significant business, regulatory and solvency concerns and has been the subject of regulatory scrutiny on and off for at least fifty years. Risk is heightened with extreme forms of fronting *i.e.* the policy issuing company has no net insurance risk and does no underwriting, claim handling or claim funding. The reinsurers involved in *Koken* and *Ario* knew or should have known that they were operating in a danger zone and might be held directly liable to policyholders should Legion or Reliance become insolvent.

The upside of the above case law, however, is that the industry now has judicial guidance as to the size and shape of the danger zone. Under the case law cited above, it appears that insureds would have a direct right of action against reinsurers only if the cedent lacks a cognizable, net insurance risk. This is not a very high standard for the industry to achieve.

ENDNOTES

1 *See generally,* Robert M. Hall, *Fronting: Business Considerations, Regulatory Concerns, Legislative Reactions and Related Case Law,* XII Mealey's Reins. Rpt. No. 14 at 22 (2001) (hereinafter *Hall*) also available at the author's website: bob@robertmhall.com.

2 *Id.*

3 *Id.*

4 831 A.2d at 1203.

5 *Id.* at 1212.

[6] *Id. at 1203.*
[7] *Id.* at 1237-8.
[8] 2007 Pa.Commw Lexis *18-9.
[9] *Id.* *10-1.
[10] *Id.* *13-4.
[11] Id. *20.
[12] *Id.* *14.