NEWSSTAND

**Issues Arising from Reinsurance of Captives**

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Reinsurance of captive insurers may present a variety of issues not usually present in the reinsurance of non-captive entities. These issues may appear at every stage of a reinsurance transaction from placement to claims handling, payment or rejection of a claim, and resolution of a dispute. There is little U.S. law specifically relevant to these issues to provide guidance. In this article, however, we suggest some questions for consideration and some possible practical solutions.

In considering the issues, it is important to keep in mind that "captives" are not a homogeneous group, and that much depends upon the factual context. Thus, there are a number of different types of captives; for example, single owner captives, group captives and association or industry captives. Depending on its ownership structure and purpose, a captive may have substantial underwriting expertise and rigorous underwriting standards, or it may accept whatever business comes its way from its parent(s). Similarly, a captive may have a professional claims-handling staff with well-defined procedures for investigation and payment, or the handling of claims may be largely a function fulfilled by the parent or parents or by a third-party administrator (TPA). In other words, insurance by a captive may be a totally arm's-length transaction, or it may fall considerably short of that standard.

**Placement Issues**
Implicit within the duty of utmost good faith, which is applicable to every reinsurance transaction, are various disclosure obligations in connection with placement of the risk.[1] In most reinsurance transactions, this duty to disclose falls solely upon the cedent; the underlying policyholder has no duty to the reinsurer (although it certainly has such a duty to its insurer).[2] In the captive case, however, where the underlying policyholder and its insurer, the ceding captive, are related, and the policy has not been underwritten on an arm's-length basis, does the policyholder then assume a direct duty of disclosure to the reinsurer?

Consider the following hypothetical. A reinsurer of a captive cedent seeks to avoid payment of a claim on the ground that material information concerning the risk was withheld from it at the time of placement. The withheld information, however, was never in the possession of the cedent; rather, it was withheld from the cedent by its parent policyholder. In this situation, does the reinsurer have a valid defense to the claim, or does the duty of utmost good faith devolve only upon the cedent, despite the fact that it is a captive? If our hypothetical situation did not involve a parent and captive, the answer would be fairly simple. If the cedent neither knew nor had reason to know that information had been withheld by its insured, it might have a defense to payment of a claim, but that defense would not benefit the reinsurer if the cedent, in good faith, decided to pay the claim. Therefore, the issue is whether that result might be changed if the cedent is a captive of the original insured.

In the absence of any case law on point, a number of approaches might be applicable. For example, a court or arbitration panel might simply decide that the reinsurer took its chances by failing to underwrite the risk properly. Under some circumstances, the captive cedent might be viewed as simply an agent for the parent insured.[3] Or an arbitration panel - - not bound by strict rules of law - - might simply ignore the corporate formalities as a matter of equity.

The imposition of a duty of disclosure on the insured parent, however, might lead to problems for the reinsurer. In the typical reinsurance transaction, there is no privity of contract between an underlying insured and a reinsurer, and thus the insured has no direct right of action against the reinsurer.[4] The relatively few cases that hold otherwise generally involve situations where the reinsurer becomes directly involved in the handling of an insured's claim or otherwise has direct interaction with an insured.[5] If an insured is held to have a direct duty to a reinsurer, it could be argued that that duty might provide the missing privity of contract and thus allow the insured to sue the reinsurer directly.

Also, from the standpoint of the reinsurer, since it is well known that the issuance of policies by captives to their parents is sometimes done on something less than an arm's-length underwriting basis, is there a duty to inquire how and by whom the reinsured risks were underwritten? In theory at least, the duty to disclose material underwriting information in utmost good faith is absolute. However, whatever a court might decide, and we are aware of no U.S. case law on this issue, in an arbitration – the forum in which most reinsurance disputes are decided – it is entirely possible that a panel would be reluctant to grant relief to a reinsurer who knew or could easily have discovered that its captive cedent had not rigorously underwritten the risk but, without inquiry, nonetheless assumed that risk.

In the same vein, if a broker is involved in the transaction, does the broker have a duty to inquire as to how the risk was underwritten?[6]

**Claims Issues**

A cedent clearly has a duty to cooperate with the reinsurer in the handling of a claim.[7] This duty may be expressed through a formal claims cooperation clause, a notice of loss clause, an access to records clause and/or a clause giving the reinsurer the right to associate in defense of a claim. However, in a captive situation, the captive cedent may be unable to offer effective cooperation with its reinsurer, even if it wishes to do so. The underwriting and claims records may be in the hands of its parent or a TPA; similarly, the claim may actually be handled by the parent rather than the captive. It might be argued that if the captive entered into a reinsurance agreement providing for these duties, knowing that it would be unable to fulfill them, there has been a breach of the duty of utmost good faith.[8] Conversely, the situation might be such that it could be argued the reinsurer had forfeited any right to cooperation by entering into a contract when it knew that the other party was incapable of extending the necessary cooperation.

In this situation, there are a number of possible strategies a reinsurer might employ. First, if the matter is in litigation, it might seek to join the parent insured or TPA as a party, assuming there is a basis for jurisdiction.[9] This might also be accomplished in an arbitration but, as we explore below, the prospects of joining in an arbitration a party who has not agreed in writing to arbitrate is uncertain. Assuming the parent can not be joined, it may be possible to obtain information from it through third-party discovery. Third-party discovery is, of course, normally available in litigation, but in arbitration there is less certainty.[10] Some federal courts have upheld the right of arbitrators to subpoena non-parties for pre-hearing depositions under the Federal Arbitration Act; others have held there is no such right.[11] Similarly, the courts are split on whether an arbitration panel can order pre-hearing document discovery from non-parties.[12] Finally, a reinsurer might attempt to get an order from the court or arbitration panel requiring the captive to seek the necessary information from its parent or TPA. However, the prospects for obtaining such an order are uncertain, and it is equally uncertain what sanctions, if any, can be imposed upon the captive cedent if it can show that it is legitimately unable to comply.

**Follow the Settlements**

The follow the settlements (or follow the fortunes) doctrine requires a reinsurer to pay claims submitted by its cedent as long as those claims are within the terms of the underlying policy and the reinsurance agreement and the claim was resolved in good faith and in a business-like manner.[13] An unwritten premise of the doctrine is that the cedent and its insured deal with each other in a professional manner at arm's length.[14] For example, if a cedent settles a claim that has no merit for the sole reason of enhancing its business relationship with its insured, follow the settlements should not require payment by the reinsured. Thus, it is often said that the doctrine requires the reinsurer to follow the insurance fortunes of its cedent, not its overall business fortunes.[15]

There are a number of possible follow the settlements issues that may emerge from reinsurance of a captive. For example, in settling a claim, did the captive exercise its own informed, professional judgment or did it, in essence, follow the instructions of its parent? Indeed, was the captive substantially involved in settlement of the claim or was that handled by the risk management department of the parent or a TPA retained by the parent? Similarly, there are issues regarding burden of proof. Generally, the reinsurer will have the burden of demonstrating that it should not be bound by follow the fortunes. However, in the captive situation where, for example, the claim was in reality handled by the parent or a TPA reporting to the parent, it might be argued that the burden of proof should be shifted to the captive cedent to demonstrate that the claim was in fact handled in a good faith and business-like manner.

We are speaking here of claims settlements that are not a product of outright collusion between the parent and captive. If in fact there was such collusion, presumably the reinsurer should prevail.

**Compelling the Parent to Arbitrate**

The parent is not a party to the reinsurance agreements between the captive and its reinsurers and would not ordinarily have the right or obligation to arbitrate pursuant to the reinsurance agreements. However, courts have explained that parties who are not signatories to an arbitration agreement may be required to arbitrate under certain circumstances. Six theories for binding a nonsignatory to an arbitration agreement have been recognized: (a) incorporation by reference; (b) assumption; (c) agency; (d) veil-piercing/alter ego; (e) estoppel; and (f) third-party beneficiary.[16]

In a recent case,[17] the court found that the reinsurers had alleged facts that would support the theory that the parent acted to receive direct benefits from the reinsurance certificates in ways that would support applying direct-benefits estoppel, such as relying on the signatories' performance of the contract containing the arbitration clause, asserting that monetary compensation is owed under the contract with the arbitration clause and receiving monetary compensation flowing from obligations under the contract with the arbitration clause. The reinsurers' allegations that the parent dealt directly with the reinsurers and sought payment directly under the reinsurance certificates alleged a plausible basis for the reinsurers to show that the parent received direct benefits under the reinsurance certificates and could be bound to the arbitration clause.

Regardless of whether or not one of the exceptions applies, the dispute itself must be arbitrable under the relevant contract. Arbitration clauses vary considerably in scope and a narrow arbitration clause may not cover all the claims in a consolidated arbitration.

**Steps for the Reinsurer**
Given the uncertainties that are frequently inherent in reinsurance of a captive, it will be prudent for the reinsurer to take whatever steps are necessary to protect itself under the circumstances. First, the reinsurer must investigate the situation thoroughly and satisfy itself that it has all relevant information, both as to the risk and the claims handling process. Second, if possible, the reinsurer should consider attempting to make the parent insured a party to the agreement and, in the agreement, clarify the responsibility of each party for providing underwriting information and claims handling. The agreement should also clarify the standards to be used in underwriting business and settling claims. In part, this might be accomplished by a cut-through, but the wiser course would be to include more detail of the sort discussed above. It is true that bringing the insured into the transaction might create a direct liability on the part of the reinsurer, but in many, or most, cases, it is best to eliminate the maximum number of uncertainties. Another approach might be to obtain representations in the agreement regarding how the risk was underwritten and how claims will be handled.

In short, obtaining the maximum clarity and certainty up front will inure to the benefit of all parties.

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Endnotes:

[1.] *See, e.g., Compagnie De Reassurance D'ile De France, et al., v. New England Reinsurance Corp., et al.*, 57 F.3d 56, 80 (1st Cir.1995); *Christiania General Ins. Corp. of New York v. Great American Ins. Co.*, 979 F.2d 268, 278-79 (2d Cir.1992).

[2.] *Republic Ins. Co. v. Masters, Mates & Pilots Pension Plan*, 77 F.3d 48 (2d Cir.1996).

[3.] A third party generally has no action against an agent in a disclosed principal situation because the contract is with the principal. *Citibank v. Nyland Ltd.*, 878 F.2d 620, 624 (2d Cir.1989) (citations omitted).

[4.] *Travelers Indem. Co. v. Scor Reinsurance Co.*, 62 F.3d 74 (2d Cir.1995).

[5.] *See Allstate Ins. Co. v. Administratia Asigurarilor De Stat*, 948 F. Supp. 285, 307-08 (S.D.N.Y.1996).

[6.] *Commonwealth Ins. Co. v. Thomas A. Greene & Co.*, 709 F. Supp. 86, 88 (S.D.N.Y.1989) (holding that the reinsurance intermediary owes a duty of utmost good faith to each of the parties in the reinsurance relationship).

[7.] *North River Ins. Co. v. Philadelphia Reins. Corp.*, 797 F. Supp. 363, 369 (D.N.J.1992).

[8.] *Compagnie De Reassurance D'Ile De France v. New England Reinsurance Corp.*, 57 F.3d 56, 74-75;1995 U.S. App. LEXIS 15037 (1st Cir.1995).

[9.] Fed. R.Civ. P.19.

[10.] Fed. R. Civ. P. 45.

[11.] *See, e.g., Life Receiveables Trust v. Syndicate 102 at Lloyd's of London*, No. 07-cv-1197 (2d Cir. Nov. 25, 2008); *Hay Group v .E.B.S. Acquisition Group*, 360 F.3d 404, 407 (2d Cir. 2004); *Matria Healthcare, LLC, et al. v. Duthie, et al.*, No. 08-C-5090 (N.D. Ill. Oct. 6, 2008); *Atmel Corp. v. LM Ericsson Telefon*, 371 F. Supp. 2d 402 (S.D.N.Y. 2005); *Odfjell ASA v. Celanese AG*, 328 F. Supp. 2d 505 (S.D.N.Y. 2004); *In re Arbitration Between The Proctor and Gamble Co. and Allianz Ins. Co.*, 2003 U.S. Dist. LEXIS 26025, at *5 (S.D.N.Y. Dec. 3, 2002).

[12.] *See, e.g., In re Sec. Life Insurance Co. of Am.*, 228 F.3d 865, 870-71 (8th Cir. 2000); *Am. Fed'n of Television and Radio Artists, AFL-CIO v. WJBK-TV*,164 F. 3d1004,1009 (6th Cir.1999); *Festus & Helen Stacy Foundation v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 432 F. Supp. 2d 1375, 1379 (N.D. Ga. 2006); compare Hay Group, Inc., 360 F. 3d at 408, 410-11; Liberty Mut. Ins. Co. v. White Mountains Ins. Group Ltd., No. 06-11901 (D. Mass. Feb. 28, 2007), reported in Mealey's Reporter: Reinsurance, Volume17, Issue 22, March 22, 2007.

13. *See Mentor Ins. Co. v. Brankasse*, 996 F.2d 506, 517 (2d Cir. 1993).

14. *Independence Insurance Co. v. Republic National Life Insurance Co.*, 447 S.W.2d 462 (Tex. Civ. App. 1969).

15. *Michigan Millers Mutual Insurance Co. v. North America Reinsurance Corp.*,182 Mich. App. 410, 452 N.W.2d 841 (1990).

16. *Thomson-CSF, S.A. v. Am. Arbitration Ass'n*, 64 F.3d 773, 776 (2d Cir.1995).

17. *ACE American Ins. Co. v. Huntsman Corp.*, 255 F.R.D. 179; 2008 U.S. Dist. LEXIS 74431 (S.D. Tex. 2008).