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Insurance Practice

Reinsurance Redux

The redux on developments in the law of reinsurance

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The United States District Court for the Eastern District of Pennsylvania granted a petition to confirm an amended arbitration award of $7,957.88 in a reinsurance dispute, finding that the court had not received any opposition to the confirmation. *Aurum Asset Managers, LLC v. Banco Do Estado Do Rio Grande Do Sul*, No. 08-mc-00102 (E.D. Pa. June 26, 2012). **PAGE 4**

Texas Supreme Court Holds that Stop-Loss Insurance is Not Reinsurance, but Rather, is Direct Health Insurance Subject to Regulation under the State Insurance Code

Texas Dep't. Ins. v. Am. Nat'l Ins., No. 10-0374, 2012 WL 1759457 (Tex. May 18, 2012).

On May 18, 2012, the Texas Supreme Court reversed the judgment of the Court of Appeals, holding that, as a matter of law, stop-loss insurance sold to a self-funded employee health-benefit plan is not "reinsurance," but rather, "direct insurance" subject to regulation under the Insurance Code.

American National Insurance Company and American National Life Insurance Company of Texas (collectively American) sell stop-loss insurance to self-funded employee health benefit plans. With a self-funded benefit plan, an employer assumes the risk of providing health insurance to its employees, instead of ceding that risk to a third-party insurance company. With plans of this nature, the employer sets aside funds or pays covered medical expenses out of its general accounts. The plans are typically administered by a third party that purchases stop-loss insurance to limit financial exposure to catastrophic losses. Under a stop-loss policy, the insurer agrees to reimburse a self-funded plan for healthcare costs that exceed a contractually predetermined amount.

The crux of the dispute was whether stop-loss insurance sold to self-funded employee health-benefit plans is "direct health insurance" or "reinsurance." The distinction is not merely an academic one; direct insurance is subject to state regulation and taxation, while reinsurance is not. American contended that an employer who self funds a health-benefit plan should be considered an "insurer" under the state's Insurance Code. American reasoned that, on these facts, the employer-insurer acts like a reinsurer because the purchase of stop-loss insurance is a redistribution of risk in the same way that a reinsurance contract redistributes risk between two insurance companies. The Texas Department of Insurance (the Department) disagreed. The Department argued that American had improperly recorded stop-loss policy premiums as "assumed reinsurance" rather than "direct written premium." The Department reasoned that because self-funded employers are not themselves "insurers authorized to do the business of insurance," then stop-loss coverage was not "assumed reinsurance." Although an employee health-benefit plan may in some ways act like an insurer with respect to the plan's participants – its employees – the Insurance Code does not regulate it as one.

The trial court granted the Department's motion for summary judgment. American petitioned the Third District Texas Court of Appeals. The Court of Appeals reversed the trial court's finding and concluded that an employer's self-funded plan did not qualify as an insurer under the Insurance Code and, therefore, stop-loss insurance was a type of reinsurance beyond the scope of the Department's control. The Department appealed to the Texas Supreme Court.

At the outset, the Court's opinion clarifies the definition of "reinsurance," which is not expressly defined in the Insurance Code and has "become confused over time" due to indiscriminate use by courts, attorneys and writers. Writing for the Court, Justice David M. Medina accepted the following definition of reinsurance – "the transfer of all or part of one insurer's risk to another insurer, which accepts the risk in exchange for a percentage of the original premium." The Court also noted that the "true reinsurer is merely an insurance company or underwriter which deals only with other insurance companies as its policyholders." Noting that the principal distinction between direct insurance and reinsurance is the nature of the purchaser, the Court concluded that "[e]mployers who self fund their employee health-benefit plans are clearly not insurance companies."

Having surveyed the key terms at issue, the Court approached the question presented as one of statutory interpretation. The Court noted that the Legislature chose not to define the terms "stop-loss insurance" and "reinsurance." And, because both

parties presented plausible interpretations, the Court found that the Insurance Code was ambiguous on how stop-loss insurance should be treated. In such an instance, the Court deferred to the Department's treatment of stop-loss insurance. The Department had promulgated a rule dictating that stop-loss and excess loss policies are in the nature of direct health insurance, not reinsurance. The Court found that the Department's construction was reasonable, formally promulgated and not expressly contradicted by the Insurance Code.

Redux in Context:

- Stop-loss insurers should take heed of administrative trends on the state level – in Texas, stop-loss coverage is not "assumed reinsurance" and self-funded employers are not "insurers authorized to do the business of insurance."
- Stop-loss policies written in Texas are subject to state insurance regulation and taxation.

United States Court of Appeals for the Second Circuit Affirms District Court's Unpublished Opinion that a Surety Bond Holder Did Not Enjoy Cut-Through Rights to Reinsurance

***Callon Petroleum Co. v. Nat'l Indem. Co.*, No. 11-241, 2012 WL 2549500 (2d Cir. July 3, 2012).**

In 2001, Callon Petroleum Company (Callon) obtained a judgment against Frontier Insurance Company (Frontier) in the United States District Court for the Eastern District of Louisiana, and was awarded $2.7 million (the Louisiana Judgment). Callon Petroleum Co. v. Frontier Ins. Co., No. 01-cv-01502 (E.D. La. 2001). The Louisiana Judgment arose out of a surety bond, issued by Frontier, that required Frontier to guarantee certain obligations due Callon in connection with a 1997 lease assignment. Before Callon could collect on the Louisiana Judgment, Frontier was placed into Rehabilitation by the New York State Superintendent of Insurance in 2001.

Callon commenced suit against the reinsurer of the bond, National Indemnity Co. (NICO) in the U.S. District Court for the Eastern District of New York on February 8, 2006, claiming that NICO breached the reinsurance agreement by not paying claims made to Frontier. Callon based its claims on Article 1 of the Aggregate Reinsurance Agreement (Reinsurance Agreement) between NICO and Frontier, which required NICO to "pay on behalf of [Frontier] any and all Ultimate Net Loss in relation to Covered Liabilities subject to the terms, conditions, exclusions and Aggregate Limit stated in this [Reinsurance Agreement]." Callon contended that Article 1 should be read to contain an implied "cut-through" right, permitting it to sue NICO directly to collect the Louisiana Judgment. Also, with regard to third-party-rights, Article 14 of the Reinsurance Agreement contained the following provision: "Nothing in this Reinsurance [Agreement], express or implied, is intended, or shall be construed to confer upon or give to any person, firm or corporation (other than the parties hereto and their permitted assigns or successors) any rights or remedies under or by reason of this Reinsurance [Agreement]." (Callon was not a party to the Reinsurance Agreement).

On December 23, 2010, the District Court granted NICO's motion for judgment on the pleadings, holding that the Second Circuit's recent finding in the related case Jurupa Valley Spectrum LLC v. Nat'l Indem. Co., 555 F.3d 87 (2d Cir. 2009), foreclosed Callon's argument that the Reinsurance Agreement had cut-through rights that would permit it to sue NICO directly (December 2010 Opinion). Relying on Jurupa, the District Court held that the Reinsurance Agreement's no-third-party-rights clause (Article 14) eliminated any implied cut-through rights Callon may have otherwise enjoyed: "The language of the present reinsurance, while it provides that the reinsurer 'shall pay all amounts due Insured,' does not specify to whom

the payments will be made. In addition, Article 14 of the Reinsurance Agreement explicitly provides that no one other than the reinsured shall have any rights or remedies against the reinsurer. The Reinsurance Agreement cannot reasonably be read to provide a 'cut through.'" *Callon Petroleum Co. v. Nat'l Indem. Co.*, No. 06-cv-0573, 2010 WL 5437210, at *4-5 (E.D.N.Y. Dec. 23, 2010). On October 11, 2011 the district court denied Callon's motion to reconsider its December 2010 Order. *Callon Petroleum Co. v. Nat'l Indem. Co.*, No. 06-cv-0573, 2011 WL 4962220 (E.D.N.Y. Oct. 11, 2011).

On July 3, 2012, the United States Court of Appeals for the Second Circuit affirmed the District Court's decision, holding that the Reinsurance Agreement did not contain a so-called "cut through" provision, and could not be reasonably read to provide for an implied "cut through." As such, it was clear that in this instance third parties (like Callon) had no rights whatsoever to reinsurance. The Court noted that typically reinsurance contracts are contracts of indemnity that offer the original assured no right of action against the reinsurer. However, New York law recognizes an exception if the reinsurance agreement contains a facially apparent "cut-through" provision granting policyholders a direct right of action against reinsurers. In the case at bar, the Court had previously determined that the contract at issue specifically provided that the agreement did not grant rights and remedies to any one, other than the reinsured.

Redux in Context:

- Cut-through right to recovery is not the default under state contract principles. To contract around the default, best practice dictates that the authorization of such third-party rights should be made expressly on the face of the reinsurance agreement.

United States District Court for the Eastern District of Pennsylvania Grants Petition for an Arbitration Award in a Reinsurance Dispute, Finding that the Court Had Not Received Opposition to the Confirmation

***Aurum Asset Managers, LLC v. Banco Do Estado Do Rio Grande Do Sul*, No. 08-mc-00102 (E.D. Pa. June 26, 2012).**

The underlying dispute concerns monies due under a reinsurance agreement. The relationship between the parties is a complicated one that spans several decades. Banco Do Estado Do Rio Grande Do Sul (Banrisul) is a state-owned bank of a political subdivision of Brazil that once owned a majority stake in Companhia Uniao de Seguros Gerais (Uniao), a reinsurance company. Uniao was a member of a reinsurance pool of Brazilian insurance companies in the 1970s and 1980s, known as Groupo de Empresas Seguradoras Brasileiras (GESB Pool). The GESB Pool entered into a quota-share retrocession agreement with Summit Fidelity, which was governed by Brazilian law. The agreement contained an arbitration provision. Under that agreement, Summit received periodic payments from Uniao. Sometime after 1981, Uniao stopped making payments.

In 1997, Banrisul sold all of its stock in Uniao to Bradesco Companhia de Seguros (Bradesco). Under the terms of the sale, Banrisul remained liable to Bradesco for Uniao's GESB Pool obligations. In June 2006, Aurum acquired the rights to reinsurance receivables from Evergreen National Indemnity Company, a successor to Summit Fidelity. It then made various attempts to contact Uniao and Bradesco to receive the sums it believed it was owed as part of the GESB Pool and was eventually informed that Banrisul was responsible for payment. After failing to elicit a response from Banrisul, in January 2007, Aurum submitted a demand for arbitration, claiming $56,230 in unmade payments and $103,328 in prejudgment interest. Banrisul failed to appear at the arbitration and, in an award issued on October 11, 2007, the arbitration panel found that Banrisul was responsible to Aurum for a total of $163,523.

Aurum then filed a petition to confirm the arbitration award in the United States District Court for the Eastern District of Pennsylvania. Banrisul did not enter an appearance. On June 24, 2008, the District Court entered an order confirming the arbitration award. On June 23, 2009, Banrisul filed a Motion to Vacate Default Judgment and Stay Enforcement Thereof, claiming that the order confirming the arbitration award was void due to a lack of subject matter jurisdiction under the Foreign Sovereign Immunities Act (FSIA).

On October 13, 2010, the District Court agreed with Banrisul and vacated the arbitration award. The District Court reasoned that Banrisul was a state-owned "agency or instrumentality" that retained immunity under the FSIA because it had not engaged in commercial activity in the United States and was not a party to the arbitration provision in the reinsurance agreement between Arum or any of Aurum's predecessors-in-interest. Aurum Asset Managers, LLC v. Banco Do Estado Do Rio Grande Do Sul, No. 08-102, 2010 WL 4027382 (Oct. 13, 2010). Banrisul was a non-signatory to the arbitration clause. Thus, Banrisul could only be bound to the arbitration agreement in limited circumstances not available here because Banrisul never exerted control over Uniao. On August 15, 2011, the United States Court of Appeals for the Third Circuit affirmed the District Court's order vacating the order confirming the arbitration award. Aurum Asset Managers, LLC v. Bradesco Companhia De Seguros, 441 F. App'x. 822 (3d Cir. 2011).

Following the Third Circuit's affirmation of the District Court's order, Aurum filed an amended petition to confirm a final arbitration award that had been issued January 17, 2012. On June 26, 2012, Judge Mary A. McLaughlin for the Eastern District granted the amended petition as it related to Bradesco and ordered Bradesco to pay Aurum $7,957.88 according to the terms set forth in the final arbitration award.

Redux in Context:

- A state-owned "agency or instrumentality" may retain immunity under the FSIA where it does not engage in commercial activity in the United States;
- Courts will not enforce an arbitration award against a non-party to the arbitration agreement.

This publication has been prepared by the Insurance Practice for information purposes only.

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