# EQUITAS AND DIRECT ACTIONS

**By**

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## I. Introduction

For purposes of this article, a direct action is a suit by a policyholder or claimant against a reinsurer in order to collect reinsurance recoverables or other damages related to the insurance provided by the cedent. In general, reinsurers are not subject to direct actions since there is no privity of contract and insureds and claimants are not the third party beneficiaries of the reinsurance transaction. It is possible, however, to create liability to an insured or claimant by indicating such an intent in the contract *e.g.* a "cut-through" on the part of the insured or claimant to the reinsurance proceeds. [1]

In general, a fronting relationship (*i.e.* one in which the cedent retains little or no risk) does not make the reinsurer susceptible to direct actions.[2] Nonetheless, the role of Equitas with respect to the business of its cedent Names has some unique characteristics which has generated considerable litigation in the United States. The purpose of this article is to explore whether and in what manner Equitas may be susceptible to direct actions in the United States.

## II. Equitas

Equitas was born out of a time of great turmoil in the Lloyd's marketplace during the late 1980's and early 1990's. A surge of losses (particularly U.S. asbestos and pollution losses), bad management and fraud threatened the solvency of many syndicates. U.S. regulators and clients questioned the security of Lloyd's.[3] To avoid meltdown, the leadership of Lloyd's formed Equitas which was designed to act as the reinsurer for all syndicate years 1992 and prior.

The reinsurance contract employed to accomplish this purpose is known as the Reinsurance and Run-Off Contract. Much can be said about this contract since it runs well over 100 pages. In brief, however, it reinsured and indemnified the Names for liabilities under insurance policies and reinsurance contracts (Part 1 § 3.1). It did not affect the liability of the Names to their clients (Recitals J) and did not create any rights on behalf of third parties (Part 1 § 3.7). In addition, the Reinsurance and Run-Off Contract provided for proportionate payment of claims should Equitas have insufficient assets to pay all claims (Schedule 3).

In order to achieve efficiencies of scale and centralize claim decisions, the Reinsurance and Run-Off Contract granted complete authority to Equitas to manage claims and related services (Part II

§ 9.2). The scope of this authority is virtually unprecedented in normal, or even abnormal, commercial reinsurance transactions. It includes complete authority to (1) negotiate, contest and settle claims with cedents, insureds and claimants; (2) hire and fire adjusters, attorneys and consultants; (3) pursue subrogation and salvage; (4) enter into commutations and other market arrangements; and (5) collect and apply reinsurance. As is discussed in § VI below, it is the very scope of this claim authority which may cause Equitas the greatest exposure to direct actions in the United States.

## III. Motivations of the Players

Usually, a direct action occurs when the policy issuing insurer is insolvent and the policyholder or claimant does not wish to share reinsurance recoverables with other creditors of the same class. Reinsurers resist direct actions for several reasons. First and foremost, reinsurers are required to pay reinsurance recoverables to the cedent or its receiver under the "Insolvency Clause" of a reinsurance contract which is a provision required by law or regulation in order for the cedent to take credit for the reinsurance. Secondly, reinsurers usually avoid direct involvement in litigation because it drives up expenses and carries the potential for conflict with the reinsurer's client.

In the Equitas context, however, the motivations of the players seem to be different. The direct actions against Equitas described below do not arise in an insolvency context. While the author claims no special insight on point, it appears that claimants bring direct actions against Equitas because Equitas has taken over the claims adjustment and payment function of its cedent Names. Claimants regard Equitas as the real party in interest, at least metaphorically, and seek to have that party before the court.

The motivations of Equitas seems to be different as well. Equitas does not seek to avoid direct liability because of its obligations to its cedents. In fact, Equitas has contracted with the Names to remit reinsurance payables to the claimants rather than to the Names. It follows also that there is no duplication of effort between the Names and Equitas and no apparent opportunity for conflict since Equitas controls the entire claim adjustment and payment function.

So then why does Equitas so vigorously resist personal jurisdiction in the cases cited below? While the author again claims no special insight, one reason could be that personal jurisdiction is a large step down the long slope toward a finding that Equitas is conducting an insurance business in the United States. Such a finding could subject Equitas to the endearing qualities of a fifty state system of regulation. This, clearly, would make the job of running off the Equitas book of business much more difficult.

## IV. Cases Finding Personal Jurisdiction over Equitas

One of the few reported cases finding personal jurisdiction over Equitas is <u>Employers Ins. of Wausau v. Certain London Market Companies</u>, 1997 WL 1134980 (W.D.Wis.). The treaty at issue contained a clause by which underwriters agreed to accept service of suit in any court of competent jurisdiction. The court characterized this as a forum selection clause. The court analyzed the issue of personal jurisdiction based on forum selection law rather than the nature of the reinsurance relationship between Equitas and the Names. The court cited precedent that a non-party to a contract may be bound by a forum selection clause where that party is closely related to the dispute and it is foreseeable that it will be bound. The court found personal jurisdiction:

. . . Equitas has assumed control over all litigation relating to disputes over defendant Names' pre-1993 policies. Such a broad grant of authority makes Equitas closely related to the dispute.

Regarding forseeability . . ., I find that when Equitas took control over the Name's pre-1993 obligations and assumed the power to litigate disputes arising out of those obligations, it should have realized it would be bound to these forum selection clauses.[4]

A more comprehensive review of insurance and reinsurance issues is presented in Equitas Reinsurance Ltd. v. Browning-Ferris Industries, Inc, 2001 WL 422765 (Ct.App.Texas). The insured, BFI, brought suit against Underwriters at Lloyd's for breach of contract and against Equitas breach of the duty of good faith and fair dealing and for violations of various Texas statutes dealing with claims handling. Equitas argued no personal jurisdiction on the bases that: (1) the claims handling activities upon which BFI asserts jurisdiction were not actionable; (2) the Texas Insurance Code does not provide an insured with a cause of action against a reinsurer; and (3) The Texas Insurance Code exempts reinsurance from the definition of the "business of insurance." The court noted that due process required that for jurisdiction, the nonresident defendant must have purposefully established minimum contacts in the state and that the exercise of jurisdiction comport with fair play and substantial justice.

The Browning-Ferris court did not reach the issue of whether BFI had a common law cause of action against Equitas by finding jurisdiction based on alleged violations of Texas claim handling statutes:

The Insurance Code prohibits any person, including adjusters, from engaging in unfair or deceptive acts in the "business of insurance." . . . The code does not limit liability to companies in contractual privity with the insured. . .

Here Equitas acknowledges that it is acting as an adjuster for the underwriters. The Insurance Code makes actionable an enumerated list of settlement practices. (Citation omitted) When BFI alleges that Equitas, as adjuster, has engaged in certain unfair claim-settlement practices, BFI has made actionable claims. Such actionable claims will support a finding of specific jurisdiction.[5]

As to the argument that there is no cause of action against a reinsurer under the Insurance Code, the court noted that the activities of Equitas under the Reinsurance and Run-Off Contract went far beyond that of the ordinary reinsurer and concluded:

Thus, Equitas, in addition to whatever reinsurance duties it owes to the underwriters, also has assumed certain claim-handling duties. Equitas, therefore, may be liable under the Insurance Code for any deceptive settlement practice it might have committed as an adjuster dealing with the insured. We do not view the Insurance Code as immunizing a party against any allegations of deceptive claims-settlement practices simply because the party may also have certain reinsurance duties.[6]

With respect to Equitas final defense, the Browning-Ferris court found that exempting "reinsurance" from the definition of "insurance" in Texas' unauthorized insurer statute did not define that term for purposes of other statutes prohibiting those engaged in the business of insurance from utilizing deceptive trade practices. Finally, the court found that asserting personal jurisdiction over Equitas comported with fair play and substantial justice since Texas has an interest in preventing deceptive trade practices within the state and Equitas had already assumed the burden of defending its cedent in Texas pursuant to the Reinsurance and Run-Off Contract.

There have been a number of unreported decisions which find personal jurisdiction over Equitas. *See e.g.* GAF Corp. v. Hartford Accident & Indem. Co., No. L-980-97 (N.J.Super.Mar.31, 2000); Unisys Corp. v. Ins. Co. of North America., No. L-1434-94S (N.J.Super.Dec. 17, 1999); Uniroyal Inc. v. American Re-Insurance Co., No. L-8172-94 (N.J.Super.Dec. 17, 1999); Employers Mut. Casualty Co. v. Owens Ins. Ltd., No. MRS-C-51-96 (N.J.Super.Nov. 10, 1999); Central Vermont Public Serv. Corp. v. Adriatic Ins. Co., No. I:96-CV-252 (D.Vt.Feb. 11, 1998). Given the lack of precedent generated by unreported cases, this article will not analyze them.

## V. Cases Finding No Personal Jurisdiction Over Equitas

A considerably larger number of cases find no personal jurisdiction over Equitas. One is these is Millennium Petrochemicals v. C.G. Jago, 50 F.Supp.2d 654 (W.D.Ky.1999) in which the plaintiff brought action against Underwriters at Lloyd's and Equitas for breach of the insurance policy, breach of the covenant of good faith and fair dealing and for bad faith settlement practices in violation Kentucky's unfair claims settlement act.

Initially, the court rejected the insured's argument that there were sufficient contacts for personal jurisdiction over Equitas since it was the successor- in- interest to the Names. The court reasoned that the Reinsurance and Run-Off Contract called for Equitas to assume authority to adjust claims but that Equitas did not assume liability for them. Secondly, the court rejected the "closely related" rationale of the Employers of Wausau court, *supra*, on the basis that the Reinsurance and Run-Off Contract rather than the forum selection clause should be the proper focus for analysis. The Millennium Petrochemical court similarly rejected the argument that the Reinsurance and Run-Off Contract was reinsurance to close which created a direct relationship between Equitas and the insured and the argument that the creation of Equitas was a reorganization of a business which should provide the insured with a direct right against Equitas:

Thus, although the Names transferred assets to Equitas in exchange for indemnification, the transaction was not the sale of a business. Therefore, as the agreement was one of reinsurance and indemnification, and not one of a successor-in-interest or sale of a business, policyholders do not have contractual privity to sue Equitas directly.[7]

For another case rejecting the successor-in-interest argument, *see* Union Pacific Railroad Co. v. Equitas Ltd., 987 P.2d 954 (Co.Ct.App.1999).

In USX Corp. v. Adriatic Ins. Co., 64 F.Supp.2d 469 (W.D.Pa.1998), the insureds alleged that the Reinsurance and Run-Off Contract affected an assignment and delegation of the Names responsibilities to insureds providing such insureds with a direct right of action against Equitas. This direct right, they argued, conferred personal jurisdiction over Equitas. The court construed the assignment and delegation argument as a third party beneficiary claim which is specifically prohibited by the Reinsurance and Run-Off Contract. In addition, the court was unpersuaded by the argument for personal jurisdiction on the basis that Equitas had assumed the roll of adjusting claims and paying losses:

Under plaintiff's theory any time a reinsurer is given authority to oversee claims which may fall within the scope of its policy, that authority would necessarily transform the reinsurance contract into one of direct assignment. Plaintiffs cite no persuasive authority for such a proposition.[8]

Plaintiffs sought personal jurisdiction over Equitas on the basis that it became the real party in interest on the insurance policy by operation of the Reinsurance and Run-Off Contract in Long Island Lighting Company v. Aetna Casualty & Surety Co., 1997 WL 567342 (S.D.N.Y.). The court rejected this argument noting that such contract provided that it did not impair or supersede the rights and obligations of Names to their policyholders.

A Name sued Equitas for proceeds of a stop loss policy in Malone v. Equitas Reinsurance Ltd., 101 Cal.Rptr.2d 524 (Ct.App.Cal.2000). Equitas had set off the proceeds of the policy against premium due to Equitas as part of its Reconstruction and Renewal Plan. The court found insufficient contacts for personal jurisdiction since Equitas did not solicit business in California and the stop loss insurance was purchased by the Name's agent in London.

There are a number of unreported decisions finding no personal jurisdiction over Equitas in the United States. *See e.g.* The Boeing Co. v. Underwriters at Lloyd's, No. 99-03873-8 SEA (Wash.Super.Dec. 21, 1999); Archdiocese of Milwaukee v. Certain Underwriters at Lloyd's, No. 96-CV-006626 (Wis.Cir.July 13, 1999); Central Maine Power Co. v. Moore, No. CV-93-489 (Sup.Ct.Me May 16, 1999); Idaho Power Co. v. Underwriters at Lloyd's, No. 97-0203-S-BLW (D.Idaho Mar. 31, 1999); First State Ins. Co. v. Minnesota Mining & Mfg Co., No. C3-94-12780 (Minn.May 1, 1997). Given the lack of precedent provided by these unreported cases, this article will not analyze them.

## VI. Liability of Reinsurers Which Assume the Claim Handling Role

Ordinarily, insureds have no right of action against a reinsurer due to lack of privity.[9] However, there are a number of cases which suggest that reinsurers subject themselves to direct actions by policyholders when they assume 100% of the risk and take over services to policyholders normally performed by the cedent.

An early example is O'Hare v. Pursell, 329 S.W.2d 614 (Mo.1959) in which the reinsurer assumed 100% of the risk, took charge of the pertinent books and records of the primary business, serviced the business, and adjusted and settled obligations directly with insureds. Under these circumstances, the court ruled that the reinsurer was directly liable to insureds:

By taking over the risk assumed by [the cedent, the] reinsurer put itself in the position of a contractor with the insureds. The law supplies the privity necessary for insureds to maintain a direct action upon the contract of reinsurance.[10]

For a case with similar facts and ruling, *see* Foremost Life Ins. Co. v. Department of Insurance, 395 N.E.2d 418 (Ct.App.Ind.1979). *But see* Appeal of Goodrich, 2 A. 209 (Pa.1885).

Another example of direct liability by conduct is Venetsanos v. Zucker, Farcher & Zucker, 638 A.2d 1333 (Sup.Ct.N.J.1994). As part of a fronting relationship, Homestead Insurance Company ("Homestead") assumed 100% of the insurance risk under a boat policy issued on the paper of Mutual Fire and Inland Marine Insurance Company ("Mutual Fire"). Homestead, its officers, employees and affiliates, produced the business, underwrote it, adjusted and settled claims and, generally, acted as if Homestead was the policy issuing company. When Mutual Fire was placed in receivership, the assignee of the policyholder filed an action against Homestead not for reinsurance recoverables, but for failure to: (1) negotiate a settlement of the underlying claim in good faith and within the policy limits; and (2) advise the policyholder of the existence of risk in excess of policy limits

The Venetsanos court recognized the usual direct action rule that reinsurance proceeds are payable to the receiver of the cedent rather than the policyholders of the cedent. However, the complete fronting nature of the transaction caused the court to uphold summary judgment in favor of the policyholder's assignee, imposing the obligation of a primary insurer on Homestead:

Here, Mutual, the local admitted insurer, merely provided the use of its policy for a consideration in order to enable a non-admitted carrier and its affiliates to solicit and evaluate risks, sell policies, wholly insure, and wholly control payments of claims on risks in this state. We will not consign a New Jersey insured or its uncompensated victim-assignee exclusively to uncertain and probably inadequate recourse against an insolvent insurer in a foreign rehabilitation proceeding in such circumstances, particularly where the reinsuring agreement is unavailable.[11]

The court did not indicate how it would have ruled had the assignee been seeking reinsurance recoverables.

A similar case is Keightley v. Republic Ins. Co., 946 S.W.2d 124 (Ct.App.Tex.1997). In this case Republic Insurance Company ("Republic") reinsured 100%[12] of the risk of National County Mutual Fire Insurance Company ("National") on the policy in question. Due to National's financial difficulties, Republic took over National's claims handling functions by assigning a claims manager for National's insureds, adjusting and settling claims, hiring defense counsel and establishing and funding a bank account in National's name for payment of claims.

The assignee of the policyholder did not seek reinsurance recoverables from Republic. It brought various statutory and common law claims against Republic for refusal to settle within the limits of the policy. Republic moved for summary judgment based on the policyholder's lack of privity with Republic. Noting that the plaintiff sought damages based on Republic's wrongful conduct rather than under the reinsurance contract, the court rejected Republic's motion for summary judgment on one statutory deceptive trade practices count and one common law negligence count that did not require privity between Republic and the insured.

A more recent case on point is Edens v. United Benefit Life Ins. Co., 2001 WL 11431140 (N.D.Tex.). United Benefit Life ("UBL") was the fronting company and its parent Central Reserve Life ("CRL") was the reinsurer. CRL agreed to perform all the administration of UBL policies "including but not limited to, all actuarial, underwriting, compliance, legal, issuance, accounting, administration, data processing, systems and claims processing services"[13] with respect to the UBL policies. The policyholder sought to recover from the reinsurer and CRL moved for summary judgment on the basis that it had no liability to the policyholder. The court declined to so rule stating:

The court's concern is that for all intents and purposes CRL was the insurer. A reasonable conclusion that might be drawn from the administrative services agreement is the UBL was simply fronting for CRL in the provision of health and accident insurance by CRL to the public. That agreement suggests that, realistically, UBL was doing no more than to provide an insurance policy and certificate forms bearing its name and address and, perhaps, a sales organization, and that all other aspects of the insurance undertaken in the name of UBL, which, pursuant to the agreement between the two, was entitled to all profits derived from policies issued in the name of UBL.[14]

The conclusion which might be drawn from these cases is that a reinsurer which assumes all the insurance risk and, by contract or conduct, creates a direct relationship with an insured may be liable directly to that insured, at least for misconduct in claim handling. The obvious significance for Equitas is that this case law would support personal jurisdiction and ultimate liability based on tort or breach of unfair insurance practices statutes. The decision of Equitas Reinsurance Ltd. v. Browning-Ferris Industries, Inc., *supra*, can be seen as one step down that road.

## VII. Conclusion

To prevent a meltdown in the Lloyd's marketplace, Equitas was formed to reinsure the liabilities and assume the claim handling responsibilities for all syndicate years 1992 and prior. Litigants against those syndicate years strive vigorously to bring Equitas before the court as a defendant and Equitas strives with equal vigor to avoid this on the basis of lack of personal jurisdiction.

To date, Equitas has been more successful than not in avoiding personal jurisdiction in the United States due to the careful draftsmanship that went into the Reinsurance and Run-Off Contract *e.g.* provisions denying any intent to create third party beneficiary relationships. However, Equitas' claims handling role may present an area of vulnerability to personal jurisdiction and direct actions which cannot be managed by contract. A growing amount of case law suggests that Equitas may have significant direct action exposure in those states which allow tort claims related to claim handling without privity and/or allow private actions based on deceptive trade or unfair insurance practices.

## ENDNOTES

[1] . *See generally* Robert M. Hall *Cut-Throughs and Guarantee Clauses*, X Mealey's Reins. Rep. No. 17 at 16 (1999).

[2] . *See generally* Robert M. Hall *Fronting: Business Considerations, Regulatory Concerns, Legislative Reactions and Related Case Law*, XII Mealey's Reins. Rep. No. 9 at 24 (2001).

[3] . *See generally* Robert M. Hall *Security Devices for Unlicensed Reinsurers*, 16 U.Pa. J. Int. Bus. Law 41 (1995).

[4] . 1997 WL 1134980 (W.D.Wis.) *8.

[5] . 2001 WL 422765 (Ct.App.Texas) *4.

[6] . *Id.*

[7] . 50 F.Supp.654 at 662.

[8] . 64 F.Supp.2d 469 (W.D.Pa.1998) at 477.

[9] . *See* T. Darrington Semple Jr. and Robert M. Hall, *The Reinsurer's Liability in the Event of the Insolvency of a Ceding Property and Casualty Insurer*, Tort & Ins. L. Jour. 407, 413 - 417 (Spring 1986).

[10] . 329 S.W.2d 614 at 622.

[11] . 638 A.2d 1333 at 1339.

[12] . The court did not specify that it was a 100% cession but the author confirmed it with Republic.

[13] . 2001 WL 1143140 *5.

[14] . *Id*. at 10.