FRONTING: BUSINESS CONSIDERATIONS, REGULATORY CONCERNS, LEGISLATIVE REACTIONS AND RELATED CASE LAW

By

Robert M. Hall

[*Mr. Hall is an attorney, a former insurance and reinsurance executive and acts as an insurance consultant as well as an arbitrator and mediator of insurance and reinsurance disputes. The views expressed in this article are those of the author and do not reflect the views of his clients.*

Questions or comments may be addressed to the author at bobhall@qsilver.net.]

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 also controls the underwriting and/or claim handling process either directly or through a managing general agency. Often, the reinsurer is not licensed in the United States.

Fronting is a troublesome practice for both the industry and its regulators. It presents both business opportunities and problems for participants. Regulators have concerns about: (a) their ability to regulate those who are controlling business in their states; and (b) solvency issues when such programs go wrong. Some states attempt to regulate or prohibit this practice. A sub-class of case law is developing which would allow insureds to collect directly from reinsurers on fronting programs despite a lack of privity.

The purpose of this article is to examine fronting from the aspect of the industry and regulators and to comment on related legislation and regulations and case law.

II. Business Considerations

A. <u>Arguments in Favor of Fronting</u>

From a primary company standpoint, fronting is often a soft market strategy to provide income without significant insurance risk. This income may serve to pay for certain support staff when they are not fully utilized. It also can give the primary company a "free" look at new books of business.

Fronting can also be a means by which a primary company enters a new insurance field gradually with the considerable financial and technical support of a reinsurer. Fronting can also be a means by which a primary insurer can exit a field when regulatory requirements mandate that business be renewed for a certain period of time.

Historically at least, it has taken many years for a primary insurer to be licensed in all states. In the interim, fronting has been used to allow an insurer to write national programs. In addition, international insurers may choose not to be licensed in the United States but have clients with operations here which need insurance. Fronting can allow such insurers to retain their clients.

During the last ten years, reinsurers have sought to protect their source of income by dealing directly with insureds, their brokers or managing general agents who control books of business. When this is the case, the primary company may be the last part of the structure to be put in place, almost as an afterthought. This is sometimes referred to as “reverse flow” business. Since reinsurers usually anticipate very favorable results in these circumstances, a bare front may be preferred.

B. Business Problems with Fronting

Fronting programs have inherent pressures which make them difficult to maintain over time. To avoid adverse selection, the primary company is often precluded from writing the same class of business as is included in the fronting program. Even if adverse selection is not an issue, an insurer may have to file rates and forms for the fronted program and will be precluded from using different rates and forms for its own programs. Should the underwriting results of the fronting program be or seem to be profitable, the primary company may seek to keep some net insurance risk. The reinsurer is likely to by annoyed by such an opportunistic effort to profit from the reinsurer’s program.

Managing general agents often control underwriting and claim handling on fronting programs. Such entities are compensated by commissions rather than underwriting results. This means that they have a motivation to write marginal business and discount rates. Likewise, their claim handling resources may be thin and they have a motivation to under reserve to preserve their commission income. This presents the primary insurer with market conduct problems which cannot be passed off to the reinsurer.

Assuming an unlicenced reinsurer, the ceding company will need security for reported and unreported losses if it is to avoid a penalty to surplus. Loss data supplied by the managing general agent may be incomplete or of questionable quality making it hard for the primary company’s actuaries to project losses. Being who they are, actuaries will make conservative projections under such circumstances which, to nobody’s surprise, may be higher than those of the reinsurer. This may well precipitate a struggle both within the primary company and with the reinsurer, over the proper level of security.

If the reinsurer is placed in receivership, the primary company is in a very difficult financial as well as practical situation. Financially, the primary is faced with paying 100% of the losses with a very small percentage of the premium. If security is exceeded, the primary insurer may become one of many creditors in a bankruptcy proceeding in the reinsurer’s country of domicile. Practically, the primary insurer may have difficulty in securing the underwriting and claim files from the entity or entities chosen to perform these functions by the reinsurer. This will precipitate additional market conduct problems.

A reinsurer also can find itself in difficult circumstances should the front become insolvent. Absent a cut-through to the insureds,[1] an association captive reinsurer is obligated to pay reinsurance proceeds to the receiver who will use them for administrative expenses and then spread them among all creditors of the same class *i.e.* to creditors other than the association members.

"Reverse flow" programs may be organized by and focused through a entity which plays a controlling role in the transaction (*i.e.* intermediary, managing general agent, underwriting manager, broker, claim manager etc.) with the primary insurer in a completely passive role. If results are not what were expected, the reinsurers may fall out of love with the entity they chose to control the program and then criticize the front company for not being more vigorous in supervising this entity. This can jeopardize the front's reinsurance protection on a program for which it never expected to have any net risk or operational responsibility.

III. Regulatory Concerns

Wariness with the fronting process by regulators goes back at least as far as the 1950's.[2] New York is the state which is most consistent in its animosity but the issue as arisen in many other states and at the National Association of Insurance Commissioners.[3]

Historically, the most commonly cited argument against fronting by regulators is that it aids and abets an unlicenced reinsurer in doing business within the state. Usually, this is a metaphorical argument since most states have very specific statutes concerning the activities of unauthorized reinsurers which constitute doing business in the state. Fronting, generally, does not violate these statutes. Nonetheless, there is legitimate concern that the entity which controls a primary insurance program within the state is beyond its jurisdiction.

The second major regulatory concern is one of solvency. Fronting transactions, by their very nature, are highly leveraged. Primary companies who engage in this practice may allow their policies to be issued on business far outside their expertise. Should the reinsurer be unwilling or unable to meet its obligations, the primary insurer may be brought down by its inability to handle the runoff as well as the necessary reduction to surplus. Regulatory concerns were echoed in a description of the insolvency of Transit Casualty in "Failed Promises: Insurance Company Insolvencies" issued by the House Subcommittee on Oversight and Investigations in 1990:

[Transit management and its] board simply ignored two fundamental flaws in their [fronting] plan. The first was Transit's enormous credit risk that its reinsurers would be unable or unwilling to pay, and the second was that Transit was completely unprepared to handle the incredible volume of [fronting] business produced by the MGAs.[4]

One of the problems encountered by regulators in regulating fronting is in defining it. Some statutes and regulations have defined fronting in terms which are mushy at best and could apply to a surprisingly high percentage of all reinsurance transactions. This has hampered the ability to regulate these transactions. *See* Section IV, *infra*.

IV. Fronting Statutes and Regulations

After intense and prolonged debate, he National Association of Insurance Commissioners ("NAIC") adopted a Fronting Disclosure and Regulation Model Act in 1992. It provides that when a licensed insurer enters into a reinsurance transaction and delegates to the reinsurer claims handling and underwriting authority, prior regulatory approval is necessary if: (1) annual gross premium for the transaction is expected to exceed 5% of the insurer's policyholder surplus; or (2) annual gross premium for all similar transactions is expected to exceed 15% of policyholder surplus. This Model has not been adopted in any state.

The Reinsurance Association of America markets a Compendium of Reinsurance Laws & Regulations which includes the topic of fronting. According to this Compendium, only 17 states and the Virgin Islands have any statutes, regulations, bulletins or attorneys' general opinions (generically called "Regulation(s)") on fronting. Those which exist are usually vague, piecemeal or overly broad. For instance, some fronting Regulations apply only to a narrow portion of the marketplace *i.e.* credit life and health, medical malpractice, home and service warranties or ambulance service agreements.[5]

In addition, some Regulations prohibit "fronting" without defining the term.[6] Other Regulations define it as "transfer of the risk of loss" or "transfer of a substantial portion of the risk of loss" or "transfer of substantially all of the risk of loss."[7] The lack of a precise definition of fronting makes both compliance and enforcement difficult. Does "risk of loss" include timing risk *i.e.* can payment of the loss be put off until investment income plus the premium exceeds the loss? Is delegation of claims handing and underwriting authority irrelevant? What percentage of risk must be ceded to be substantial or substantially all risk? How is this measured in excess of loss or aggregate excess cessions? For instance, an insurer may cede only the first $500,000 of $1,000,000 limits but due to the underlying policy limits and/or the nature of the business, the reinsurer could actually pay virtually 100% of the losses.

Without better definitions, it is possible that garden variety quota share cessions will be regarded as fronting by regulators. For instance, the Florida fronting statute, § 624.404, defines fronting as a 50% cession to one unauthorized reinsurer or 75% to two such reinsurers. Perhaps the better approach is that taken by the NAIC and by Connecticut in defining fronting based on delegation of the insurer's power, rather than any specific quantity of risk transferred. Connecticut Bulletin S-2 prohibits transactions in which:

[L]icensed insurance companies have entered into agreements with unlicenced insurance companies, which agreements enable the unlicenced insurance company in the name of the licenced company to do, among other things, (1) appoint agents; (2) collect premiums; (3) adjust losses; (4) process, approve and issue checks in payment of claims and expenses; and (5) maintain all records associated with such business.

V. Liability of Reinsurers to Insureds in Fronting Situations

Ordinarily, insureds have no right of action against a reinsurer due to lack of privity.[8] 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.[9]

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).

Another example of 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: (a) negotiate a settlement of the underlying claim in good faith and within the policy limits; and (b) 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.[10]

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%[11] 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"[12] 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.[13]

The conclusion which might be drawn from these cases is that a fronting reinsurer which, by contract or conduct, creates a direct relationship with an insured will be liable to the insured for the its misconduct.

VI. Conclusion

From a business standpoint, fronting has two benefits: (1) it allows reinsurers to run primary insurance programs without being licensed as such or establishing the mechanisms to service insureds; and (2) its gives primary insurers the opportunity to profit from fronting fees without incurring significant insurance risk. While the first benefit may be real, the second is often illusory given the highly leveraged nature of the transaction, the adverse interests inherent in the relationship and the particular vulnerability of the front when something goes wrong. Many insurers have learned through sad experience the pitfalls of fronting.

From a regulatory standpoint, the first business benefit noted above is not a benefit at all. Regulators observe that reinsurers which lack the proper licenses or mechanisms to service policyholders should not be doing so. Since these reinsurers may be beyond regulatory jurisdiction, regulators lack the authority to protect consumers from any improprieties committed by these reinsurers. Should the transaction fall apart, the front company may be damaged financially in an irretrievable fashion, forcing the insurance department to take over the company and for guaranty funds to adjust and pay losses. Notwithstanding these dangers, fronting statutes and regulations are so piecemeal and vague as to be almost wholly ineffective in achieving the goals of regulators.

The courts, however, are recognizing heightened liability to insureds when reinsurers take over the functions of their cedents. If effect, reinsurers are being held to the same standards as insurers when they act as insurers rather than reinsurers.

ENDNOTES

---

[1] .   *See* Robert M. Hall, *Cut-Throughs and Guarantee Clauses*, X Mealey's Reins. Rpt. No. 21 at 18 (2000).

[2] .   Robert M. Hall, *Fronting: Here We Go Again*, Best's Review, 53 at 56 (December 19990).

[3] .   *Id.* at 117.

[4] .   *Id.*

[5] .   For instance, *see* Maryland § 13-116, Massachusetts .§175:193U, Missouri § 83-57-49, Oklahoma 36 § 6627, Pennsylvania Notice of 10/27/73, Virginia § 38.2-2614 and Virgin Islands 22 § 1695.

[6] .   For instance, *see* Idaho Attorney's General Opinion of 1/14/74, Kentucky statute 806 KAR 5:020, Massachusetts § 175:193U, New York Circular Letters 1958-1 and 1958-2, New York Office of General Counsel Opinions Nos. 83-9, 92-84 and 92-122 and Pennsylvania Notice of 10/27/73.

[7] .   For instance, *see* Maryland § 13-116, Missouri § 83-57-49, Nevada § 690A.260, North Carolina § 58-1-35, Oklahoma 36 § 6627 and Virginia § 38.2-2600.

[8] .   *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).

[9] .   329 S.W.2d 614 at 622.

[10] .   638 A.2d 1333 at 1339.

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

[12] . 2001 WL 1143140 *5.

[13] . *Id*. at 10.