IS REINSURANCE THE "BUSINESS OF INSURANCE?"[1]

By Robert M. Hall[2]

The McCarran-Ferguson Act, 15 U.S.C. § 1011-1012, provides a form of pre-emption of state insurance law over those federal statutes which do not specifically relate to insurance. This pre-emption, however, is limited to state laws which regulate the "business of insurance." In the foreseeable future, it may be necessary to determine whether or not reinsurance, in part or whole, qualifies as the "business of insurance." The issues which may require such a determination include: (a) ancillary receiverships for non-U.S. insurers pursuant to 11 U.S.C. § 304 of the Federal Bankruptcy Code (hereinafter "§ 304"); and (b) competition with the Federal Government over priority in distribution of assets of the estate of an insolvent domestic insurer.

The McCarran-Ferguson Act.

The key language of this Act, for present purposes, is contained in 15 U.S.C. § 1012(b):

- No act of Congress shall be construed to invalidate, impair, or supercede any law enacted by any State for the purpose of regulating the business of insurance . . . unless such act specifically relates to the business of insurance. . . .

(emphasis added).

Thus, state laws regulating the "business of insurance" supercede federal statutes which do not relate specifically to insurance. Not everything done by insurance companies, however, is the "business of insurance." The Supreme Court has adopted a three part test on point: (a) whether the practice has the effect of transferring or spreading a policyholder's risk; (b) whether the practice is an integral part of the policy relationship between the insurer and the insured; and (c) whether the practice is limited to entities within the insurance industry.[3]

In applying this standard, the Supreme Court has ruled "that 'ancillary activities' that do not effect performance of the insurance contract or enforcement of contractual obligations do not enjoy" the pre-emption.[4] Thus, use of a peer review process for charges by chiropractors is not the "business of insurance."[5] Neither are agreements with pharmacies which provide goods and services to insureds.[6] Below is an examination of the legal precedents and arguments relating to inclusion of reinsurance within the "business of insurance."

Existing Case law

To date, the U.S. Supreme Court has declined two opportunities to rule on this issue. One opportunity was *Hartford Fire Ins. Co. v. California*, 509 U.S. 764 (1993), a massive anti-trust case against various parties including insurers and reinsurers. The decisions in the underlying courts had addressed squarely whether reinsurance was the "business of insurance" but the Supreme Court chose not to hear this issue on appeal.[7]

The second opportunity was *U.S. Dept. of Treasury v. Fabe*, 508 U.S. 491 (1993). The issue in this case was whether a state statute determining the priority of distribution of an insolvent insurer's assets was superseded by a federal statute giving the Federal Government priority over all other creditors (hereinafter "super-priority statute").[8] The Court held that the state statute did regulate the "business of insurance" to the extent that it addressed the performance of insurance policies.[9]

The opinion did not mention reinsurance and a number of the Court's comments make it difficult to assess the impact of *Fabe* on the present issue. At one point the Court cited its earlier decision[10] that the "business of insurance" includes that which impacts on the reliability of policies issued to insureds: "Undoubtedly, other activities of insurance companies relate so closely to their status as reliable insurers that they too must be placed in the same class."[11] This language seems to fit well with the various functions of reinsurance to: (a) stabilize insurers' results; (b) increase insurers' capacity; and (c) protect insurers against catastrophes.[12]However, the Court observed that the state statute did not regulate the "business of insurance" to the extent that it offered creditors other than policyholders a priority above that of the Federal Government.[13] This might suggest that general creditors, such as insurers, which ceded reinsurance to the insolvent insurer, are subordinated to the super-priority statute. On balance, it is not evident what impact, if any, *Fabe* has on whether or not reinsurance is the "business of insurance."

Lower court cases, however, have been very supportive of the proposition that reinsurance is the "business of insurance." One early case is *Feinstein v. Nettleship Co.*, 714 F.2d 928 (9th Cir. 1983) *cert. denied* 466 U.S. 972 (1984). This case involved an antitrust charge by a physician against an agent, a primary insurer and its reinsurers on the basis that physicians had to join an association to participate in the association's medical malpractice program. The court ruled that the antitrust laws were pre-empted, pursuant to McCarran-Ferguson, by state laws regulating rates and market practices of insurers.

The district court in *Hartford* gave the reinsurance issue extended analysis.[14] It rejected arguments that reinsurance does not directly relate to the spreading of a policyholder's risk and is not an integral part of the policy relationship between the insurer and the insured. The court found that by protecting against

catastrophe risk and providing additional capacity, reinsurance "effects the ability and willingness of primary insurers to provide insurance to their customers."[15] The court found that both reinsurance and retrocessions are the "business of insurance."[16] The court of appeal upheld this portion[17] of the district court's ruling and the issue was not heard at the Supreme Court level.

Another case supporting reinsurance as the "business of insurance" is *Stephens v. American Int'l. Ins. Co.*, 66 F.3d 41 (2nd Cir. 1995). This case involved a state statute that prohibited reinsurance arbitrations with insolvent insurers. Referring to the Supreme Court's three part test (noted above) for the "business of insurance", the court of appeals stated:

- Reinsurance practices fall within this test. Any transaction between an insurer and a reinsurer is principally the same as a transaction between an original policyholder and an insurer, as both center around the transfer of risk. Furthermore, reinsurance is not merely "an integral part of the policy relationship between the insurer and insured," it is the policy relationship between the two parties. Finally, the practice of reinsuring insurers is a practice "limited to entities within the insurance industry."[18]

Thus, while the U.S. Supreme Court has not squarely addressed the issue, there are several lower court decisions that strongly support the proposition that reinsurance is the "business of insurance" for McCarran-Ferguson purposes.

Implication for § 304 and Super-Priority Issues

§ 304 applies to insurers which are not doing business in the United States but have assets there. This can include offshore reinsurers and surplus lines insurers which have posted security for the protection of their U.S. clients.[19] § 304 allows the bankruptcy court to: (a) prohibit creditors from attaching these assets; and (b) allow removal of the assets to the insurer's domiciliary jurisdiction where U.S. creditors must go to make their claims in accordance with that jurisdiction's bankruptcy law.[20] This may work a hardship for clients who have relied on the availability of such security in the U.S.

The interaction between § 304 and McCarran-Ferguson was addressed recently in *In re Laitsalo*, (95-B-40385 and 95-B-40386) (Bank. Ct. S.D.N.Y. March 12, 1996). In this case the Pennsylvania Insurance Commissioner was protesting an injunction against her attempt to obtain pre-answer security pursuant to New York law.[21] The judge characterized the Commissioner's actions as an attempt to gain a preference over other creditors, and noted that the New York Superintendent of Insurance was not attempting to enforce his own state law. Ignoring the language of the pre-answer security statute, the judge ruled that the totality of New York liquidation law was consistent with § 304 in supporting equitable distribution of estate assets. Therefore, the Pennsylvania

Commissioner could not obtain a preference over other creditors. Since § 304 was consistent with New York liquidation law, there was no need for a McCarran-Ferguson pre-emption.

While the *Laitasalo* court did not reach the issue of reinsurance as the "business of insurance," future factual variations may do so. State liquidation laws commonly structure: (a) the rights of insurers and reinsures to set off obligations; and (b) the obligation of reinsurers to pay losses to an insolvent estate.[22] State credit for reinsurance laws commonly require that security posted by unlicensed reinsures be immediately available for just such an eventuality as the reinsurer's insolvency.[23] With a more squarely posed conflict with McCarran-Ferguson, a result different from that in *Laitsalo* is more likely.

The conflict between the super-priority statute[24] and reinsurance in the liquidation context is the second issue ripe for determination in the near future. Insurers which ceded reinsurance to or assumed reinsurance from an insolvent insurer are sometimes ranked higher than the Federal Government in state asset distribution priority statutes.[25] In addition, states commonly allow such insurers to set off mutual debts and credits with the estate prior to making a distribution to creditors,[26] such as the Federal Government. Either situation can pose the McCarran-Ferguson pre-emption question.

A strong argument can be made that McCarran-Ferguson should pre-empt both § 304 and the super-priority statute in the reinsurance context.
The *Laitsalo* court strained to find a lack of conflict between § 304 and a pre-answer security statute. The Supreme Court in *Fabe* held that state liquidation laws regulate the "business of insurance." Shortly after Laitsalo was decided, the Supreme Court stated in *Barnett Bank of Marian County v. Nelson*, 116 U.S. 1103 at 1107 (1996):

- Many federal statutes with potentially pre-emptive effect, such as the bankruptcy statutes, use general language that does not appear to "specifically relate" to insurance, and where these statutes conflict with state law that was enacted "for the purpose of regulating the business of insurance," the McCarran-Ferguson Act's pre-emption rule shall apply.

(emphasis added).

There is very strong case law in the Court of Appeals for the Second and Ninth Circuit interpreting reinsurance as the "business of insurance." This case law supports the critical role played by reinsurance in providing capacity and stability for the insurance buying public.

Conclusion

The McCarran-Ferguson Act allows state laws regulating the "business of insurance" to pre-empt federal statutes that do not directly focus on insurance. While the U.S. Supreme Court has not yet indicated its direction on point, there are significant case law and policy arguments supporting the interpretation of reinsurance as being within the "business of insurance." Under these circumstances, there is a substantial likelihood that state laws relating to reinsurance will pre-empt the super-priority statute and § 304 of the Bankruptcy Code since they have a negative impact on reinsurance which is important to the financial capacity and stability of primary insurance companies.

ENDNOTES

1. This article was previously published in Mealy's Reinsurance Reports.

2. Mr. Hall practices insurance and reinsurance law, and is active in both arbitrations and mediations. The views expressed in this article do not represent the opinions of Mr. Hall's clients. Copyright 1996 Robert M. Hall. Comments and questions can be addressed to *robertmhall@erols.com*.

3. *Union Labor Life Ins. Co. v. Pireno*, 458 U.S. 119 (1982).

4. *Id.* at 134, n. 8.

5. *Id.* at 130.

6. *Group Life & Health v. Royal Drug Co.*, 440 U.S. 205, 213-214 (1979).

7. *Hartford Fire Ins. Co. v. California*, 509 U.S. 764 (1993). Instead, the Court examined: (a) whether a domestic insurance company loses its McCarran-Ferguson pre-emption by participating with non-U.S. insurers; (b) whether agreements among such insurers and reinsurers constitute a boycott; and (c) did the underlying court properly assess the extra-territorial reach of U.S. anti-trust laws.

8. 31 U.S.C. § 3713 reads as follows:

(a)(1) A claim of the United States Government shall be paid first when;

(A) a person that is indebted to the Government is insolvent and

(i) the debtor is without enough property to pay all debts makes a voluntary assignment of property;

(ii) property of the debtor, if absent, is attached; or

(iii) an act of bankruptcy is committed.

9. *U.S. Dept. of Treasury v. Fabe*, 508 U.S. 491 at 506 (1993).

10. *Id.* at (S. Ct. 2207) quoting *SEC v. National Securities, Inc.*, 393 U.S. 453, 460 (1969).

11. *Id.*

12. *Fundamentals of Property-Casualty Reinsurance*, Reinsurance Association of America, 2-3 (1994).

13. *Fabe* at 517.

14. *In re Antitrust Litigation*, 723 F.Supp. 464 (N.D. Cal. 1989).

15. *Id.* at 473.

16. *Id.* at 474.

17. *In re Antitrust Litigation*, 938 F.2d 919 (9th Cir. 1991).

18. *Id.* at 44.

19. § 304 reads as follows:

(a) A case ancillary to a foreign proceeding is commenced by the filing with the bankruptcy court of a petition under this section by a foreign representative.

(b) Subject to the provisions of subsection (c) of this section, if a party in interest does not timely controvert the petition, or after trial, the court may --

(1) enjoin the commencement or continuation of --

(A) any action against --

(i) a debtor with respect to property involved in such foreign proceeding; or

(ii) such property; or

(B) the enforcement of any judgment against the debtor with respect to such property, or any act or the commencement or continuation of any judicial proceeding to create or enforce a lien against the property of such estate;

(2) order turnover of the property of such estate, or the proceeds of such property, to such foreign representative; or

(3) order other appropriate relief.

(c) In determining whether to grant relief under subsection (b) of this section, the court shall be guided by what will best assure an economical and expeditions administration of such estate, consistent with --

(1) just treatment of all holders of claims against or interests in such estate;

(2) protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in such foreign proceeding;

(3) prevention of preferential or fraudulent disposition of property of such estate;

(4) distribution of proceeds of such estate substantially in accordance with the order prescribed by this title;

(5) comity; and

(6) if appropriate, the provision of an opportunity for a fresh start for the individual that such foreign proceeding concerns.

20. Robert M. Hall, *Security Devices for Unlicensed Reinsurers*, 16 U. Pa. J. Int'l. Bus. Law 41, 79-82 (1995) (hereinafter "Security Devices").

21. N.Y. Ins. Law § 1213 (1996).

22. *See e.g.*, § 34 and § 36 of the Insurers Rehabilitation and Liquidation Model Act of the national Association of Insurance Commissioners (hereinafter "Model Act").

23. Security Devices at 42-46.

24. *See* note 6, *supra*.

25. *See e.g.*, 40 P.S. § 221.44 (d) and (e) (1996).

26. *See e.g.*, § 34 of the Model Act.