THE PERILS OF CAPTIVE INSURANCE COMPANIES:

GUARANTEES AND KICK-BACKS

By

Robert M. Hall

[*Mr. Hall is a former law firm partner, a former insurance and reinsurance company executive and acts as a reinsurance and insurance consultant and expert witness as well as an arbitrator and mediator of insurance disputes. The views expressed in this article are those of the author and do not reflect the views of his clients.* *Further information about the author and his other articles may be viewed on his website: robertmhall.com.*

I. Introduction

Captive insurance companies are often formed by commercial insureds or trade associations in an effort to gain control of, and reduce the costs of, their insurance. Program managers and lenders sometimes form captives to garner profits from the business they produce. Captive programs sometimes involve the use of a licensed insurer to front for the captive, a process that carries its own perils.[1] Whatever the structure of or motivation for the program, however, being in the insurance business involves a number of perils that the captive owners may not have appreciated entirely when the captive was formed. The purpose of this article is to examine two recent cases which exemplify these perils.

II. Guarantees by Captive Owners

When the structure of a captive program calls for a licensed insurer to issue and service policies and cede a portion, sometimes a very substantial portion, of the risk to the captive, the licensed insurer must consider its credit risk. Credit for reinsurance laws require that unlicensed and unaccredited reinsurers post security for their obligations if the ceding insurer is to take credit for the reinsurance in its financial statements. Given the long tail involved in much captive business, the ceding insurer must be concerned with the captive's continuing willingness and ability to secure its' obligations, particularly should results turn negative. Thus the cedent may seek guarantees of performance from the captive's parent or shareholders.

An example of the downside of such guarantees is *Everest National Ins. Co. v. Sutton*, 2008 U.S. Dist Lexis 62081 (D.NJ). Centrix, owned by Robert Sutton, originated sub-prime auto loans, placed them with third party lenders and arranged for default protection insurance to protect such lenders. When Centrix was given notice that its program insurer would not renew the relationship, Centrix entered into negotiations with Everest to take over the program insurer role. Eventually, such an agreement was reached with Everest agreeing to cede reinsurance to Founders Insurance Company, a captive affiliate of Centrix. As an inducement for such cession, Robert Sutton and other related entities agreed to guarantee the obligations of Founders to Everest.

Thereafter, a dispute arose between Founders and Everest which went to arbitration. The panel ordered Founders to post security in the amount of $70 million but Founders failed to do so. As a result, Everest sought to execute on the guarantees. The instant case involved motions for partial summary judgment on the guarantees and to dismiss Sutton's counterclaims.

Sutton's initial defense on the motion for partial summary judgment was economic duress. Sutton argued that Everest sprung a non-negotiable demand for the guarantees when it was too late in the process to find and gear up another insurer to take over the program. Everest responded that it should not be deprived of very valuable rights simply because Centrix failed to seek alternative insurers for the program until it was too late to do so effectively.

The court articulated the test for economic duress as having two parts: (a) the party claiming it must be the victim of a wrongful or unlawful act or threat; and (b) the party must have been deprived of its will as a result.[2] The court found no economic duress under this standard noting that driving a hard bargain is not economic duress. Centrix caused its own problem by not seeking alternative insurers. Moreover, the guarantors provided no evidence that they, as opposed to Centrix, were under economic distress.

Sutton's second defense was that the guarantors were fraudulently induced to enter the guarantees by verbal assurances that they were a mere formality and would never be enforced. The court rejected this defense ruling that the parole evidence rule prohibits a party from seeking to contradict the express terms of a writing to avoid obligations that party knowingly assumed.[3] Moreover, the guarantors reaffirmed their obligations in several subsequent agreements. Finally, the court dismissed Sutton's counterclaims related to duress but declined to dismiss a counterclaim alleging improper payment on loans that did not meet underwriting guidelines.

The guarantors took another run at this issue in *Everest National Ins.Co. v. Sutton*, 2009 U.S. Dist. Lexis 96091 (D.NJ.). In this case, Everest sought to dismiss various counterclaims or, in the alternative, for summary judgment. Some additional facts became relevant in this case, namely, that Everest sought and received advice from the New York Insurance Department that the default protection insurance it sought to write was not financial guaranty insurance, which can be written only by a mono-line insurer.

A new counterclaim alleged by the guarantors was civil conspiracy in providing misleading information to regulators concerning the business it intended to write (the financial guaranty issue) and failing to pay proper premium taxes. The court rejected this counterclaim ruling that the gravamen of civil conspiracy was that the underlying wrong provided a cause of action and that there was no private write of action for the wrongs alleged. [4] The court also rejected counterclaims of material misrepresentation and negligent misrepresentation as barred by the statute of limitations.

The guarantors also raised three affirmative defenses concerning the enforceability of the guarantees. The court dismissed these defenses on the bases that enforceability had already been decided in Phase I and that there was nothing preventing the guarantors from raising the additional defenses at that time:

> While it is true, as the Defendants point out, that the Court's summary judgment Opinion only addressed the validity of the defenses of fraudulent inducement and

> duress, this is only because those were the only defenses Defendants raised in response to the motion. The fact that the Court did not previously rule on other defenses *because they were not raised* does not allow the Defendants to continue to assert new defenses simply because they are permitted to amend their pleadings. The underlying issues have already been decided on summary judgment . . . .[5]

The moral of the story is that a guarantee is a guarantee.

III. Kick-Backs to Mortgage Lenders from Mortgage Insurers

Alston v. Countrywide Financial Corp., 2009 U.S. App. Lexis 23822 (3rd Cir.) was a class action by Pennsylvania residents who obtained home loans from Countrywide Financial in 2005 and 2006. Because these borrowers were unable to pay 20% down, they were required to purchase mortgage insurance for the benefit of Countrywide from a handful of mortgage insurers. These insurers reinsured a portion of the risk with Balboa Reinsurance Co., an affiliate of Countrywide. From the opinion, it appears that the reinsurance was on an aggregate excess of loss basis covering a band of losses *e.g.* between 4% and 14%. Plaintiffs alleged that Balboa had received $892 million in premiums for such reinsurance since 1999 and never paid a loss.

Plaintiffs alleged that such arrangements with Countrywide's captive reinsurer constituted kick-backs and fees for no services to Countrywide from the mortgage insurers. The Real Estate Settlement Procedures Act of 1974 ("RESPA"), 12 U.S.C. § 2607 prohibits kick-backs and fees for no services with respect to "federally related" mortgage loans. RESPA grants a private cause of action for damages equal to three times the amount of the "charge paid."

Countrywide sought to dismiss the action on the basis that plaintiffs could show no damages. The mortgage insurance rates charged were in accordance with the rates for such insurance approved by the Pennsylvania Insurance Department. Countrywide argued that under the "filed rate doctrine" that rates approved by a governing regulatory body are unassailable in a judicial proceeding.[6]

The court rejected this defense finding that the right granted under RESPA was for homeowners seeking loans to be free of kick-backs and fee for no service arrangements, regardless of the impact on the rates:

> Statutes like RESPA are enacted to protect consumers from unfair business practices by giving consumers a private right of action against service providers. Plaintiffs may not sue under the veil of RESPA if they simply think that the price they paid for their settlement was unfair. Alternatively, plaintiffs bringing a suit under RESPA may allege a violation of fair business practices through the use of illegal kickback payments. The filed-rate doctrine bars suits from the former class of plaintiffs and not the latter.[7]

The court of appeals reversed the district court's dismissal of the suit.

IV. Commentary

The *Everest National Insurance Co. v. Sutton* cases embody several unremarkable lessons. Insurance is a risky business. Losses, and the speed of settlement of such losses, can exceed expectations. Personal guarantees of corporate obligations can prove to be very expensive to the guarantors. Program managers, when seeking a new policy issuing company, should have several options available to avoid hard decisions, with dire consequences, at the last moment.

Alston v. Countrywide Financial Corp. may have a much more profound impact. Certainly, it may spark a wave of suits involving mortgage insurance and the significant numbers of lender-related captives used by mortgage insurers as reinsurers for marketing reasons. However, plaintiffs have a long way to go to prove their respective cases. Given the recent (and continuing) housing crisis, a 0% loss ratio, or anything near that, seems unlikely for reinsurers attaching at a relatively low aggregate loss ratio. Moreover, how does one determine when a healthy underwriting profit becomes a kick-back? Given the volatility of excess of loss results, over what period of time should results be measured? Should calendar year or accident year calculations be used? How must underwriting profits flow in the insurance holding company system for them to amount to a kick-back to an affiliated lender?

Notwithstanding the difficulty of such questions, there is a possibility that the thrust of *Alston v. Countrywide Financial Corp.* will spiral outward to the sale or leasing of goods to which insurance is attached. It is not difficult to imagine similar suits against other lenders, program managers or sellers or lessors of goods when affiliated insurance or reinsurance is part of the transaction. Neither is it difficult to imagine a plethora of consumer protection statutes providing private remedies for generally described wrongs (*i.e.* unfair and deceptive practices) being brought to bear on alleged insurance or reinsurance kick-backs. This is particularly the case for those lines of business without filed rates or in those states or lines in which a filing does not connote regulatory approval.

ENDNOTES

[1] *See* Robert M. Hall, *Fronting: Business Considerations, Regulatory Concerns, Legislative Reactions and Related Case Law,* XII Mealey's Reins. Rpt. No. 14 at 22 (2001), also available at the author's website: robertmhall.con.

[2] 2008 U.S. Dist. Lexis 62081*14.

[3] *Id.*20.

[4] *2009* U.S. Dist. Lexis 96091*7.

[5] *Id.*19-20 (emphasis in the original).

[6] 2009 U.S. App. Lexis 23822*28.

[7] *Id.*30-31 quoting *Kay v. Wells Fargo & Co.*, 247 F.R.D. 572,576 (N.D.Cal. 2007).