WHEN DOES A REINSURER HAVE A

CAUSE OF ACTION AGAINST AN INSURED?

By

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I. Introduction

There is abundant case law to the effect that absent unusual language in the reinsurance contract (*i.e.* a cut-through)[1], an insured cannot bring a cause of action against a reinsurer due to lack of privity. However, there is very little guidance in case law as to the circumstances under which a reinsurer can maintain a cause of action against an insured. The purpose of this article is to examine a recent case which sheds light on this issue.

II. Background

Underwriters at Lloyd's v. Warrantech Corp., 2004 U.S. Dist. Lexis 17086 (N.D.Tex.) involved an insurance policy issued by Houston General to Warrantech on the latter's warranty program. Lloyd's reinsured Houston General and Warrantech administered the warranty claims. Lloyd's declined to pay reinsurance recoverables to Houston General on the basis that Warrantech paid fictitious and inflated claims. Houston General demanded arbitration against Lloyd's claiming $46 million in damages.

The arbitration panel awarded Houston General $39 million without providing any findings of fact or otherwise explaining its award. Thereafter, Lloyd's brought an action for fraud and negligent misrepresentation against Warrantech arguing that it (Lloyd's) was subrogated to the rights of Houston General. Warrentech pleaded the affirmative defenses of collateral estoppel and res judicata and counterclaimed for fraud and unfair and deceptive trade practices.

The posture of the case was a motion by Lloyd's for partial summary judgment to strike Warrentech's affirmative defenses and counterclaim.

III. Court Ruling on Warrantech's Affirmative Defenses

The court found that Warrantech could not meet the technical standards for the assertion of res judicata by a non-party to the arbitration between Lloyd's and Houston General *i.e.* being in privity with Houston General and the interests it represented in the arbitration. The court held:

> As for privity, the record reflects that Houston General argued that it and plaintiffs [Lloyd's] would have recourse against Warrantech for failing to properly perform its job. (citation omitted) It could hardly be said that Houston General was representing defendant's interests in the arbitration proceeding. There are no facts that would support the conclusion that defendants were in privity with Houston General in the arbitration proceeding.[2]

Likewise, the court ruled against Warrantech's claim that Lloyd's was collaterally estopped from re-litigating issues necessarily and finally adjudicated in the arbitration. In some cases, courts have expressed frustration with the lack of a reasoned decision in their attempts to interpret the panel's award.[3] In this case, however, the lack of a reasoned decision worked in favor of the reinsurer and against Warrentech's argument that the panel found that the underlying claims were not fraudulent:

> The record indicates that the arbitration award could have been based, for example, on the follow-the-fortunes doctrine, which would not require a conclusion that the insurance payments made by Houston

> General were not the result of fraudulent or negligent conduct on the part of Warrantech, or a conclusion that plaintiffs had failed to persuade the arbitration panel that the insurance payments were made by reason of fraudulent or negligent conduct on the part of Warrantech. [4]

IV. Court Ruling on Warrantech's Counterclaims

The court rejected Warrartech's counterclaims for fraud and breach of duty of good faith and fair dealing. It found that Warrantech had no contractual relationship with Lloyd's which would create the privity necessary for breach of good faith and that there was no evidence of fraud. In addition, the court ruled that there was no basis for a counterclaim under state unfair practices laws.

V. Conclusion

In its ruling on this partial summary judgment motion, the court did not reach the merits of Lloyd's claims against the insured, Warrantech. However, the necessary implication of this case is that a reinsurer has a cause of action against an insured to the extent that the reinsurer has paid fraudulent claims submitted by an insured. While there may be no privity between the insured and the reinsurer, subrogation provides an equitable vehicle to allow the injured party to seek recovery against a wrongdoer. [5]

ENDNOTES

[1] *See* Robert M. Hall, Cut-Though and Guarantee Clauses, X Mealey's Reins. Rpt. No. 21 at 18 (2000) or view it on the author's website: robertmhall.com.

2. 2004 U.S. Lexis Dist. 17086*9.

[3]. *See* Halligan v. Piper Jaffray, 148 F.3d 197 at 204 (2nd Cir. 1998) *cert. denied* 529 U.S. 1034 (1999); Houdstermaaschappi v. Standard Microsystems Corp., 103 F.3d 9 at 12 – 13 (2nd Cir.1997); Siegel v. Titan Industrial Corp., 779 F.2d 891 at 893 – 4 (2nd Cir.1985).

[4]. 2004 U.S. Lexis Dist. 17086*13.

[5]. For an examination of a related issue, *see* Robert M. Hall, Reinsurer Claims to Subrogation and Salvage Recoveries in a Receivership Context, XXII Mealey's Reins. Rptr. 11 at 21 (2000), also available at the author's website: robertmhall.com.