Potential Problems with Reinsuring Self-Insurers

By

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I. Introduction

Self-insurers regulated by states are often required to purchase insurance coverage as a means of demonstrating their financial security. Usually, this coverage can be in the form of excess insurance or reinsurance. Many insurers who chose to participate in this market find it preferable to structure the transaction as reinsurance in order to be free of market conduct and rate and form regulation as well as premium taxes, guaranty fund assessments and other regulatory and financial overhead involved in primary and excess insurance.

In a number of cases, the reinsurance structure has survived challenges.[1] The purpose of this article is to present selected caselaw in which the reinsurance structure did not survive challenge.

II. Direct Action by the Insured

The recent decision of *Janocha's Case,* 93 Mass. App. Ct. 179 (Ct.App.2018) involved a workers compensation self-insurer that purchased excess of loss reinsurance from ACE with an attachment point of $400,000 pursuant to a security statute reading:

> As further guarantee of a self-insurer's ability to pay the benefits provided for by this chapter to injured employees, every self-insurer shall make arrangements satisfactory to the department, by reinsurance, to protect it from extraordinary losses or losses caused by one disaster.[2]

The self-insurer became insolvent before its payments to an injured worker reached the attachment point. Nonetheless, the court ruled that the reinsurer had to compensate the insured worker:

> [T]he "further guarantee" clause of § 25A(20(c) requires the reinsurer to pay benefits to employees in the event the self-insurer becomes insolvent . . . avoiding an otherwise inevitable gap in coverage. . . .
> [A] party is unable to contract away its statutory obligation, and we routinely void provisions that run contrary to law. . . . . Simply put, ACE entered into a reinsurance policy between itself and the employer with full knowledge that the act required ACE to "further guarantee" payment of compensation to the employee.[3]

Lincoln County Port Authority v. Allianz Global Risks US Ins. Co., 315 P.3d 934 (MT 2013) involved a municipal self insurance pool that purchased what the court characterized as excess of loss insurance from Allianz. (The decision does not elaborate on the form taken by the insurance.) One of the counties that was a member of the pool created a separate public entity called the Port to foster economic development. When one of the Port's buildings burned down a controversy arose as to whether the Port was an insured under the Allianz policy. An issue arose as to whether or not Allianz was actually acting as a reinsurer and if so, whether the Port was an insured that had no direct right of action against Allianz. However, the court held that the Port was Allianz's insured and that the burned building qualified as insurer property under the policy.

III. Rate and Form Filings and Assessments

Commissioner of Insurance v. American Nat. Ins. Co., 410 S.W.3d 843 (Tex. 2012) involved stop loss coverage provided to qualified, self-funded employee benefit plans sponsored by various governmental and private entities. It is not clear from the opinion whether the relevant coverage documents were styled as policies or reinsurance contracts. However for financial statement purposes, the insurer treated the premiums it received as resulting from reinsurance assumed. During a routine audit, the Texas Insurance Department discovered this practice and alleged that the coverage was insurance rather than reinsurance and that the insurer should have paid premium taxes and complied with other regulatory strictures applicable to insurance.

After a detailed examination of Texas statutes, the court found the insurance code ambiguous on point but decided to defer to the position of the Insurance Department that the coverage was insurance and not reinsurance:

> The Department has therefore concluded that stop-loss insurance purchased by a plan does not involve two insurers and is therefore not reinsurance. It is instead direct insurance in the nature of health insurance because stop-loss policies are purchased by the plans ultimately to cover claims associated with their health-care expenses. The Department's construction is reasonable, was formally promulgated, and is not

> expressly contradicted by the Insurance Code. We accordingly agree with the Department's construction and hold that stop-loss insurance sold to a self-funded employee health-benefit plan is not reinsurance, but rather direct insurance subject to regulation under the Insurance Code.[4]

IV. Guaranty Fund Claims

When an insurer providing coverage to a self-insurer becomes insolvent, the issue arises as to whether the self-insurer can make a claim against the guaranty fund. A claim is viable if the insurer is an excess insurer but not if it is a reinsurer.

One such case is *Alabama Ins. Guaranty Assoc. v. Assoc. of General Contractors,* 80 So. 3d 188 (AL 2010). AIGA was qualified self-insurer providing workers compensation coverage to the employees of its members. Several such employers formed the Alabama Reinsurance Trust Fund to allow them to pool their liabilities above the retention levels of the individual members. The Trust Fund laid off a portion of its liability to Reliance National Indemnity Co. pursuant to a "Certficate of Reinsurance" which stated that it provide reinsurance to the Trust Fund, rather than any type of coverage to the individual employer members. Reliance witnesses maintained this the coverage was reinsurance, rather than excess insurance. However, the administrator of the Trust Fund provided an affidavit that the Trust Fund was merely a broker to obtain insurance for the Trust Fund members and the parties to the limitation entered into a stipulation consistent with this affidavit.

Based on the court's reading of Alabama law, plus an affidavit from the Alabama Insurance Department, the court concluded that neither the AIGA nor the Trust Fund were insurers for purposes of the guaranty fund law. The court also concluded that notwithstanding the fact that the Reliance Certificate of Reinsurance took the form of reinsurance, it could had to be treated as direct insurance since: (1) a reinsurer can only reinsurer a ceding insurer; and (2) neither the AIGA nor the Trust Fund are insurers.

V. Judicial Articulation of the Case Against Treatment as Reinsurance

There is a significant amount of caselaw interpreting insurance coverage provided to self-insurers as reinsurance.[5] One of these cases is *Alabama Ins. Guaranty Assoc. v. Reliance Ins. Cos. in Liquidation,* 100 A.3d 702 (Pa. Commw. Ct. 2014). The dissent in this case is the best judicial analysis as to why such coverage should be treated as insurance rather than reinsurance.

The author of the dissent, Judge Leavitt, noted that:

> [R]einsurance is a transaction between two insurance companies. The custom developed to call a transaction between a self-insurer and an insurance company "reinsurance," even though a self-insurer is, by definition, not an insurance company. The custom is of some vintage.[6]

The judge noted substantial confusion among courts and attorneys (as well as enabling legislation for self-insurers) as to the distinction between excess insurance and reinsurance and went on to comment:

> [A]n excess insurance policy, purchased from an insurance company, provides financial stability to a self-insured plan. The excess policy does this by assuming the self-insured plan's risk of catastrophic claims in exchange for payment of premium. This is direct insurance between a consumer and an insurer. [7]

The dissent recognized the motivation of this use of a reinsurance format was to avoid regulation and commented that the reinsurance form of the coverage should not be determinative of how it is treated for regulatory purposes. In this case, the dissent argued that the "reinsurance" provided by an insolvent insurer should be treated as insurance for purpose of guaranty fund coverage – a significant issue for the self-insurer.

VI. Comments

It is clearly more advantageous for insurers to structure their coverage of self-insurers as reinsurance rather than excess insurance. It frees the insurer from market conduct, rate and form regulation and guaranty fund assessments and other charges involved in direct insurance. Insurers should consider whether a reinsurance structure may stand up to judicial scrutiny should a dispute arise and consider the ramifications to themselves and their clients if a court rejects this structure.

ENDNOTES

[1] *See* Robert M. Hall, *Excess of Loss Coverage for Self-Insurers: Is it Insurance or Reinsurance (Revisited),* Reinsurance, Vol. 7, No. 7 at 5 (2015), (hereinafter "Hall") also available at the author's website, robertmhallard.com.

[2] Massachusetts General Laws c. 152, § 25A(2)©, as appearing in St. 1949, c. 441, § 4.

[3] 93 Mass. App Ct. 179 at 187.

[4] 419 S.W.3d 843 at 855.

[5] *See* Hall.

[6] 100 A.3d 702 at 715.

[7] *Id.*