

## FRONTING ARRANGEMENTS: INDUSTRY PRACTICES AND REGULATORY CONCERNS

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*During the past decades, there have been multiple discussions on the issue of fronting arrangements. In general terms, a fronting arrangement can be considered as an alternative risk transfer method (ART)<sup>1</sup> where an insurer licensed in a certain jurisdiction (fronting insurer) issues a policy to cover local risks but all or virtually all of such risks are then ceded or reinsured with an unlicensed carrier (reinsurer), who will normally take over the administration of all claims related to the risks.<sup>2</sup> In exchange for its services, the fronting company normally receives a small percentage of the total premium.<sup>3</sup> It can be said, therefore, that the fronting company issues a policy and appears to the world to be an insurer, but in reality it has actually passed on to a given reinsurer most or all of the risk of coverage<sup>4</sup> and most claim-handling obligations.*

*The debate surrounding this practice has focused on multiple subjects, such as whether the fronting practice is a way to circumvent state statutes,<sup>5</sup> whether the fronting practice is good or bad when analyzed from the perspective of the policyholder<sup>6</sup>, the regulators,<sup>7</sup> or the industry,<sup>8</sup> and*

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<sup>1</sup> See Thomas Holzheu, *Alternative Risk Transfer (ART) Products*, in *Reinsurance: Fundamentals and New Challenges* 113, 117 (Ruth Gastel ed., 4th ed. 2004).

<sup>2</sup> See *Reliance Ins. Co. v. Shriver, Inc.*, 224 F.3d 641 (7th Cir. 2000).

<sup>3</sup> See ROBERT H. JERRY, II & DOUGLAS R. RICHMOND, *UNDERSTANDING INSURANCE LAW* 1017 (4th ed. 2007).

<sup>4</sup> See ERNEST H. GORE, *PROPERTY/CASUALTY INSURANCE: A BASIC GUIDE* 160 (2008).

<sup>5</sup> See, e.g., Salvatore R. Curiale, *The Dark Side of Fronting*, *RISK MANAGEMENT*, Jan. 1991, at 26-27.

<sup>6</sup> See, e.g., Fred A. Simpson, *When Fronting Carriers Fail, Equity Protects Policyholders*, 8 *J. TEX. INS. L.* 2 (2006).

*also whether the practice should be banned or further regulated. As will be examined in this article, some regulatory attempts relating to the fronting practice have been discussed by the National Association of Insurance Commissioners (NAIC),<sup>9</sup> while certain jurisdictions have gone beyond the attempt and have actually enacted statutory provisions on this matter. In addition, there is case law examining this practice and recent rulings are worthy of thought.*

*Given the above considerations, this article seeks to provide a thorough analysis of this practice, the motivations for companies to support it, as well as its negative aspects and associated risks. This article will also examine regulatory reactions, statutes, and recent case law dealing with the subject of fronting.*

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## I. INTRODUCTION TO FRONTING ARRANGEMENTS

### A. DIVERSITY OF DEFINITIONS

As noted above, the practice of fronting involves an insurance company that issues a policy, which is then completely reinsured with a reinsurance carrier. This reinsurance carrier is usually unlicensed in the jurisdiction of interest. Notwithstanding some approaches to reach a definition of fronting and although most regulators would agree that fronting includes a cession of an entire line or class of insurance to an unlicensed carrier who controls the underwriting and claims decisions, there is no common definition among the states or within the industry.<sup>10</sup> Moreover, one could validly argue that this practice has the characteristics of a “chameleon”, because fronting may take different forms and appearances depending on the specific motivation for its use.

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<sup>7</sup> See, e.g., NEW YORK INS. DEP’T, FRONTING QUESTION PRESENTED: LEGAL OPINION, (Jan. 14, 2005), <http://www.ins.state.ny.us/ogco2005/rg050111.htm>.

<sup>8</sup> See, e.g., Howard W. Greene & Jon Harkavy, *Fronting is a Consumer Right*, RISK MANAGEMENT, Jan. 1991.

<sup>9</sup> See Vincent J. Vitkowsky & John L. Ingersoll, *Survey of 1992 Developments in the Public Regulation of Insurance*, 28 TORT & INS. L.J. 408, 408 (1993).

<sup>10</sup> See NAC Reinsurance Corp., Reinsurance Contracts: Content and Regulation 33 (1991) (unpublished material, available from NAC Reinsurance Corp., One Greenwich Plaza, Greenwich, CT 06836).

For example, fronting arrangements can be used to insure risks that a company cannot write directly.<sup>11</sup> When fronting is used to write business directly in a state where a given insurer is not licensed, it has been described by a Court as an arrangement through which a state-licensed insurance company issues certain policies, which are immediately reinsured to 100 percent of their face value by an out-of-state unlicensed insurer.<sup>12</sup> Such Court explained:

In a fronting arrangement - a well-established and perfectly legal scheme - policies are issued by a state-licensed insurance company and then immediately reinsured to 100 percent of their face value by the out-of-state, unlicensed insurer. In a typical fronting arrangement, the fronting insurer issues policies on its own paper and in its own name, and the out-of-state unlicensed insurer takes over the administration of all claims as part of the reinsurance agreement<sup>13</sup>.

When a fronting arrangement is used for self-insurance purposes, a Court described the fronting policy as "a form of self-insurance in which the deductible is identical to the limits of liability, and the insurance company acts only as surety that the holder of the fronting policy will be able to pay any judgment covered by the policy."<sup>14</sup> On a more aggressive court approach, it has been said that "[i]n a fronting policy, the insured essentially rents an insurance company's licensing and filing capabilities, but the insurance company does not actually pay any claims."<sup>15</sup> In this sense, by using fronting as a self-insurance mechanism, an insured can retain all of the risks originally covered by the fronting policy.<sup>16</sup>

Focusing on self-insurance and the captive<sup>17</sup> market, it has been said that fronting denotes a practice whereby "a commercial insurance

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<sup>11</sup> JERRY & RICHMOND, *supra* note 3.

<sup>12</sup> Reliance Ins. Co. v. Shriver, Inc., 224 F.3d 641, 643 (7th Cir. 2000).

<sup>13</sup> *Id.*

<sup>14</sup> Landers v. Lucent Technologies, Inc., Nos. 81506, 81531, 2003 WL 21468908, at \*2 (Ohio Ct. App. June 26, 2003).

<sup>15</sup> Dorsey v. Fed. Ins. Co., 798 N.E.2d 47, 51 (Ohio Ct. App. 2003).

<sup>16</sup> Tharp v. Berdanier, No. CIV.A. 21473, 2003 WL 22900646, at \*4 n.3 (Ohio Ct. App. Dec. 10, 2003).

<sup>17</sup> A captive insurance company can be defined as a "company formed to insure the risks of its parent corporation." HARVEY W. RUBIN, *DICTIONARY OF INSURANCE TERMS* 70 (5th ed, 2008).

company ("fronting company") licensed in the state where a risk to be insured is located, issues its policy to the insured," and such risk is then fully transferred to a captive insurance company.<sup>18</sup> Consequently, the insured obtains a policy issued on the paper of the commercial insurance company, but, economically, the risk of that coverage resides with the captive insurance company.<sup>19</sup>

Some authors conceptualize fronting as a specialized form of reinsurance.<sup>20</sup> While by examining common definitions of reinsurance,<sup>21</sup> the motivations for its use,<sup>22</sup> and its usual purposes<sup>23</sup> one could think of valid arguments against such conceptualization, it is difficult to differentiate between fronting and traditional reinsurance practices.<sup>24</sup> Even

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<sup>18</sup> See John Prescott & Deborah Lambert, *What's Up Front: A Guide to Fronting Arrangements*, Mar. 1 2002, <http://www.captive.com/newsstand/jlcovt/Fronting.html>.

<sup>19</sup> *Id.*

<sup>20</sup> Holzheu, *supra* note 1, at 116 n.2. See also Prescott & Lambert, *supra* note 18.

<sup>21</sup> Reinsurance is normally defined as "insurance for insurance companies." JERRY & RICHMOND, *supra* note 3. It can be defined as "the transaction whereby the assuming insurer in consideration of premium paid, agrees to indemnify the ceding company against all or part of the loss which the latter may sustain under the policy or policies which it has issued." See REINSURANCE ASS'N OF AMERICA, *FUNDAMENTALS OF PROPERTY AND CASUALTY REINSURANCE* 47 (2008).

<sup>22</sup> It is argued that the "fundamental objective of insurance, to spread the risk so that no single entity finds itself saddled with a financial burden beyond its ability to pay, is enhanced by reinsurance". NAC Reinsurance Corp., *supra* note 10, at 1. In the same sense, "[r]einsurance is a mechanism used by the insurance industry to spread the risks it assumes from policyholders. Through it, the industry's losses are absorbed and distributed among a group of companies so that no single company is overburdened with the financial responsibility of offering coverage to its policyholders." Donald A. McIsaac & David F. Babbel, *The World Bank Primer on Reinsurance* 1 (World Bank Fin. Sector Dev. Dep't, Working Paper No. 1512, 1995).

<sup>23</sup> Normal motivations for reinsurance reside in the fact that reinsurance can increase an insurer's underwriting capacity, stabilize its profits from fluctuations, reduce unearned premium reserves, and provide protection against catastrophic losses. See GEORGE E. REJDA, *PRINCIPLES OF RISK MANAGEMENT AND INSURANCE* 116 (10th ed. 2008). From an economic perspective, one of the most important functions of reinsurance is the insurer's ability to take balance sheet credit for the amount of reinsurance coverage protection it holds. Deirdre G. Johnson, *Unlocking the Mysteries of Reinsurance*, 760 PRACTISING L. INST. 243, 255 (2007).

<sup>24</sup> See Greene & Harkavy, *supra* note 8.

though customary reinsurance definitions normally recognize the possibility that an insurer could potentially transfer “all” of the risk under a given policy,<sup>25</sup> one could argue that the fronting practice in principle does not seem to fit with the objectives, types, and purposes of reinsurance as to qualify as a specialized form of reinsurance. For example, fronting does not seem to pursue spreading risks within a given mass but actually involves the full transfer of a set risks to a reinsurer, who seems to act more like an insurer and less like a reinsurer. Moreover, fronting normally involves the transfer of claim handling obligations, which in traditional reinsurance are normally held by the underlying insurer.<sup>26</sup>

As noted above, one of the uses of fronting arrangements is to permit a reinsurer to write coverage that it cannot do directly.<sup>27</sup> Therefore, in this author’s opinion and for the purposes of this article, fronting will be considered as an arrangement that uses reinsurance as its transfer vehicle<sup>28</sup> and, therefore, as one of its components, but not necessarily constituting by itself a specialized form of reinsurance.

Aside from the situation described above, there is another practice that has been conceptualized as fronting reinsurance. “[F]ronting arrangements devised by direct insurers and reinsurers have been replicated by reinsurers and retrocessionaires” in the higher layers of coverage.<sup>29</sup> Unlicensed or unaccredited reinsurers may turn to other reinsurers to serve as fronts for reinsurance contracts in order to meet solvency, security or other statutory requirements,<sup>30</sup> thereby enabling the underlying insurer to obtain credit for the reinsurance coverage. When agreement is reached, the fronting reinsurer will issue the required reinsurance and will retrocede all or a significant portion of the risk to the unlicensed or unaccredited

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<sup>25</sup> See, e.g., JERRY & RICHMOND, *supra* note 3; REINSURANCE ASS’N OF AMERICA, *supra* note 21.

<sup>26</sup> See Aviva Abramovsky, *Reinsurance: The Silent Regulator?*, 15 Conn. Ins. L.J. 345, 372 (2009).

<sup>27</sup> JERRY & RICHMOND, *supra* note 3.

<sup>28</sup> In this sense, fronting has been defined as “arrangements by which an insurer, for a specified fee or premium, issues its policies to cover certain risks underwritten or otherwise managed by another insurer or reinsurer. The insurer *then transfers* all, or substantially all, of the liabilities thereunder to such insurers *by means of* reinsurance”. REINSURANCE ASS’N OF AMERICA, *supra* note 21, at 31 (emphasis added).

<sup>29</sup> BARRY R. OSTRAGER & MARY KAY VYSKOCIL, *MODERN REINSURANCE LAW AND PRACTICE* 1-25 (2d ed. 2000).

<sup>30</sup> *Id.*

carrier.<sup>31</sup> Fronting practices at these layers of coverage can enable an unlicensed or unaccredited alien reinsurer to effectively provide coverage without having to comply with the trust fund requirements that are customary for unlicensed alien reinsurers. This situation was explained by a federal court in New York when analyzing a case where a carrier acted as a front for a reinsurance syndicate from London.<sup>32</sup> The court explained:

Plaintiff ASRIC is an insurance company organized under Delaware law . . . Elkhorn/Delta was a member of a reinsurance syndicate in London managed by Stetzel Thomson & Co. Ltd. . . . Elkhorn/Delta was one of twenty-two members of this syndicate and the only member incorporated in the United States . . . According to ASRIC, because Elkhorn/Delta was the only member incorporated in the United States, Stetzel designated Elkhorn/Delta as the “fronting” company for the syndicate . . . Under the law of Delaware, ASRIC's state of incorporation, an insurer will receive reinsurance credit only if the reinsurer is licensed to transact insurance in Delaware or in another state with comparable standards of insolvency for insurance companies. If the reinsurer is an unincorporated alien insurer, the reinsured can obtain reinsurance credit only if the reinsurer establishes a trust fund here for the benefit of the reinsured.” Because most states have comparable standards, the fronting arrangement allowed ASRIC to obtain a reinsurance credit for all the risks ceded to Elkhorn/Delta, without the other members of the syndicate having to post security in the United States.<sup>33</sup>

Considering the various uses and forms of fronting, the development of a precise definition is not a simple task. Moreover, the definition that a given jurisdiction may adopt would probably depend on the specific concerns that such jurisdiction may find in the practice of fronting. Nevertheless, by examining the common elements of its various uses, the author of this article considers that a definition of fronting could be proposed as follows:

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<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *American Special Risk Ins. Co. v. Delta America Re Ins. Co.*, 836 F. Supp. 183, 184-85 (S.D.N.Y., 1993).

Fronting describes a series of alternative risk-transfer methods that share the following common elements: a) the presence of a company (fronting company) that issues an insurance or reinsurance policy, which is then completely or substantially ceded to a carrier (assuming carrier), b) the assuming carrier is normally unlicensed or unaccredited in the jurisdiction where the fronting company is licensed or accredited, c) the assuming carrier normally controls the underwriting and claims decisions of the respective policy or policies.

B. PURPOSES AND MOTIVATIONS.

Considering the variety of definitions and uses of fronting arrangements, it is reasonable to infer that these risk-transfer schemes can respond to various purposes and motivations, which depend on the specific business of a given company or group of companies. In general terms, it can be said that fronting arrangements may respond to one or more of the following motivations:

\* *For Licensing Purposes*: By means of a fronting arrangement, a carrier is enabled to write coverage that it cannot do directly<sup>34</sup> by using the services of a fronting company that is licensed in the state of interest. Such a risk-transfer method may be used where the insurer is not licensed to write business or a specific line of insurance in a particular state, and where the specific - and sometimes multi-state - insurance program would require such licensure<sup>35</sup>.

A fronting program may permit an insurer to write national programs during the time its' state licenses are being processed.<sup>36</sup> It may also be an appropriate tool when "statutory prohibitions serve to undercut an insurer's longstanding relationship with its insured."<sup>37</sup> Needless to say, this licensing motivation is normally subject to strong criticism by state

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<sup>34</sup> JERRY & RICHMOND, *supra* note 3.

<sup>35</sup> See Larry P. Schiffer, *Up-Front About Reinsurance*, INT'L RISK MGMT. INST. (Jan. 2004), <http://www.irmi.com/expert/articles/2004/schiffer01.aspx>.

<sup>36</sup> See Robert M. Hall, *Fronting: Business Considerations, Regulatory Concerns, Legislative Reactions and Related Case Law* (2001), <http://www.robertmhall.com/articles/frontingdoc.htm>.

<sup>37</sup> Curiale, *supra* note 5.

regulators,<sup>38</sup> who see this as a way to circumvent state statutes, as will be noted in Section III of this article.

\* *For Rating Reasons*: Sometimes an insurance program or an insured will require a certain financial rating for a carrier to be qualified.<sup>39</sup> When this situation occurs and the interested carrier does not fulfill the rating requirement or later suffers a downgrade of its rating that could force it to exit the program, the interested carrier may use the services of a fronting company in order to comply with such rating requirements.<sup>40</sup>

\* *For the Purpose of Entering or Exiting a Given Market*: Fronting can be the mechanism through which a carrier may gradually enter a new insurance field with the financial and technical support of a reinsurer.<sup>41</sup> By using a fronting arrangement, a carrier may gradually test an insurance line or a whole market with additional security and protection. Conversely, fronting can also be a sound tool where a carrier wishes to exit a given field but regulatory requirements oblige the business to be renewed for a certain period of time.<sup>42</sup> The carrier will continue to renew the business during the required time period but completely transfer its risks to a given reinsurer.

As it will also be noted in Section III below, there is a significant caveat on this motivation, which is that despite the transfer of risk, the company may have not entirely freed itself from its liability and related obligations.<sup>43</sup>

\* *For the Functioning of Captive Companies*: There are situations in which a company or a group of companies consider that the creation of a “captive” insurance company, which they own and control, provides a method of obtaining insurance coverage for their operations in a more

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<sup>38</sup> For example, as addressed by the Committee on Insurance of the Association of the Bar of the City of New York in 1993, “[t]o insurance regulators, the term fronting usually has a pejorative connotation, implying a situation in which the reinsurance arrangement is a matter of form between a licensed ceding company and an unlicensed reinsurer, the purpose of which is to allow the unlicensed reinsurer to do indirectly what the state prohibits it from doing directly: sell insurance within the state. Regulators view fronting as a device which enables an unlicensed reinsurer to avoid the restrictions to which it would be subject if it were a licensed insurer directly issuing insurance policies to the public . . . .” OSTRAGER & VYSKOCIL, *supra* note 29, at 1-37.

<sup>39</sup> See Schiffer, *supra* note 35.

<sup>40</sup> *Id.*

<sup>41</sup> Hall, *supra* note 36.

<sup>42</sup> *Id.*

<sup>43</sup> See Abramovsky, *supra* note 26, at 372.

efficient and productive manner.<sup>44</sup> Captives can be defined as special purpose insurance companies which are created for insuring or reinsuring the risks of its parent company or associated corporation.<sup>45</sup> In this type of ART method, fronting is said to be a necessary service for the success of captive insurers.<sup>46</sup>

Because captives are normally off-shore or out-of-state companies<sup>47</sup> that would probably not comply with statutory requirements for insurers, a majority of captives lack the required licenses to transact business of insurance.<sup>48</sup> The captive operation, therefore, normally requires the existence of a fronting arrangement to enable the risk-transfer mechanism.<sup>49</sup> Because of the size<sup>50</sup> and popularity<sup>51</sup> of the captive business, one would think that the majority of fronting arrangements probably occur within the captive market arena.

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<sup>44</sup> See JERRY & RICHMOND, *supra* note 3.

<sup>45</sup> Thomas F.X. Hodson & Cathleen T. Heath, *The Outlook for Fronting (Special Report: Captives & ART)*, RISK & INSURANCE (Mar. 1, 2002).

<sup>46</sup> *Id.*

<sup>47</sup> The primary jurisdictions where captives are incorporated are Bermuda, the Cayman Islands, and the state of Vermont. See TOWERS PERRIN, CAPTIVES 101: MANAGING COST AND RISK 1, <http://www.captive.com/service/TowersPerrin/images%20and%20pdf/Captives%20101.pdf>.

<sup>48</sup> Hodson & Heath, *supra* note 45 (“Generally, a company must be licensed to do business in the jurisdiction in which a policy is issued. A majority of captives lack the required licenses to do business and, therefore, captives often must use a fronting arrangement in order to do business in a state in which its parent’s risks are located. A fronting insurer is a licensed carrier that issues the policies that a captive cannot issue.”).

<sup>49</sup> See *id.* (“A typical fronting arrangement will operate as follows: (i) the captive’s parent pays a premium to the fronting insurer; (ii) the fronting insurer issues a policy to the parent; (iii) the fronting insurer cedes the balance of the remaining premiums back to the captive; and (iv) the captive may retrocede a portion of the risk to a reinsurer.”).

<sup>50</sup> See TOWERS PERRIN, *supra* note 47 (“Captive insurance is big business. More than 40% of major U.S. corporations and many multinational companies own one or more captives.”).

<sup>51</sup> As a curious note, even the teams of the National Football League (NFL) created in 1984 a Bermuda captive for the purposes of reinsuring the teams’ workers’ compensation insurance through fronting arrangements, although such company ended in liquidation proceedings. See *N.F.L. Ins. Ltd. v. B & B Holdings, Inc.*, No. 91 CIV. 8580, 1993 WL 78090 (S.D.N.Y. Mar. 18, 1993).

It has been noted that the use of captives and fronting arrangements normally increase in times of hard market conditions.<sup>52</sup> The hardening of the market creates a series of challenges for companies such as increased cost of risk management programs, decreased coverage, changes in terms and conditions of coverage, reduced limits or capacity offered at renewal, and increased deductibles and retentions mandated by carriers.<sup>53</sup> This market situation normally causes a significant number of companies to seek alternative risk-transfer schemes, such as the use of captives and fronting arrangements. As noted in recent industry surveys, fronting is an essential service for the captive industry.<sup>54</sup>

\* *For Tax Deduction Purposes:* Although this motivation is normally linked with the operation of captive insurers, it is appropriate to treat it separately due to its importance. Normally, a company that chooses to insure its operations through a captive company would wish to achieve tax deductibility of its premiums through successful risk-shifting.<sup>55</sup> The reasons are obvious; while premiums paid to a captive insurance company are deductible as business expense for tax purposes, the sums set aside in a self insurance program are not deductible as a business expense.<sup>56</sup>

It is important to point out that on December 11, 2009 the Internal Revenue Service (IRS) released two Private Letter Rulings, where it approved the use of a captive reinsurance arrangement involving a fronting insurer.<sup>57</sup> In these rulings, the IRS analyzed the situation where a group of

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<sup>52</sup> See Hodson & Heath, *supra* note 45.

<sup>53</sup> *Id.*

<sup>54</sup> The 2010 results of the annual survey conducted by the Captive Insurance Companies Association (CICA), show that 100% of consulted captive entities rated the overall level of importance of fronting to their captive as either very important or important. Other aspects of interest follow: a) 78% of respondents said that having an A rated fronting company as very important, b) 85% of respondents listed admitted paper among the primary reasons for using a front, c) 46% of respondent listed regulatory compliance among the primary reasons for using a front, and d) 89% of respondents characterized the price of fronting as reasonable. See *United States: 2010 Survey Results on Fronting and Reinsurance Released by CICA*, PRWEB (March 11, 2010), <http://www.prweb.com/pdfdownload/3689674.pdf>.

<sup>55</sup> See Prescott & Lambert, *supra* note 18, at 1.

<sup>56</sup> See RUBIN, *supra* note 17, at 70.

<sup>57</sup> See *IRS Approves Captive Reinsurance Arrangement as "Insurance" for Tax Purposes*, SONNENSCHNEIN CLIENT ALERT (Feb. 4, 2010), [http://www.snr Denton.com/news\\_\\_insights/alerts/irs\\_approves\\_captive\\_reinsuran.a.spx](http://www.snr Denton.com/news__insights/alerts/irs_approves_captive_reinsuran.a.spx).

individuals formed a captive reinsurer, which ultimately reinsured certain risks originally insured by a fronting company.<sup>58</sup> The IRS considered that the captive reinsurance arrangements constituted insurance for tax purposes, since risk shifting and risk distribution were present in such arrangements.<sup>59</sup>

## II. ARGUMENTS IN FAVOR OF FRONTING ARRANGEMENTS

Despite the criticism and regulatory concerns towards fronting arrangements, it is unquestionable that such arrangements continue to exist today and with few exceptions remain unregulated. One could then validly think that these arrangements are not only widely used, as noted above in relation to the captive market, but must also have positive opinions and supporters.

In general terms, fronting arrangements have been considered as valid and legal mechanisms of risk-transfer by both courts and some industry experts.<sup>60</sup> The *Reliance* Court for instance described fronting arrangements as well-established and perfectly legal schemes.<sup>61</sup> Similarly, a footnote in the *Tharp* Court decision described fronting programs as legal

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<sup>58</sup> *Id.* “In the facts of each PLR, a group of individuals formed a domestic captive reinsurer (the Company) which ultimately reinsured certain risks of two groups of entities. One group of entities (the related entities) was owned by the shareholders of the Company; the other group of entities (the unrelated entities) was unrelated to the Company. The risks of each entity were insured by a fronting insurer; portions of the insured risk were reinsured by two intermediate reinsurers before being ultimately reinsured by the Company.”

<sup>59</sup> *Id.* “The PLRs held that the Company’s captive reinsurance arrangement constituted insurance for tax purposes, applying the definition of insurance enunciated in the seminal 1941 Supreme Court case of *Helvering v. LeGierse*, 312 U.S. 531 (1941). The Court stated in *LeGierse* that, in order for an arrangement to constitute insurance for tax purposes, risk shifting and risk distribution must be present. . . . A private letter ruling such as the PLRs constitutes binding authority only for the taxpayer to whom it is issued. Nonetheless, such a ruling is viewed as expressing the current views of the IRS with respect to the subject matter of the ruling.”

<sup>60</sup> *See, e.g., Simpson, supra* note 6, at 1 (“Through variations of these arrangements, companies enjoy a lawful and cost effective way to self-insure losses without meeting the formal legal requirements to qualify as insurers (or self-insurers) in those jurisdictions where the companies do business.” *See also* JERRY & RICHMOND, *supra* note 3 (“Although ‘fronting’ has a pejorative connotation in most usages, fronting in insurance is often highly appropriate.”).

<sup>61</sup> *See Reliance Ins. Co. v. Shriver, Inc.*, 224 F.3d 641, 643 (7th Cir. 2000).

risk management devices.<sup>62</sup> Considering the potential levels of coverage where fronting may occur, it has been noted that both insurer-reinsurer and reinsurer-retrocessionaire fronting contracts have been upheld in the face of challenges to their validity.<sup>63</sup> It must be noted that even though fronting is a controversial subject, most commentators do not address whether it is legal or not, they simply note that it is an existing practice that causes significant concerns.<sup>64</sup>

Upon analyzing the question of whether New York Insurance Laws restricted or prohibited fronting, the New York Insurance Department concluded that proper licenses shall be obtained if an unauthorized insurer, under the guise of reinsurance, engaged in activities that would require a license.<sup>65</sup> Nonetheless, the Department acknowledged that the Insurance Laws do not preclude an unauthorized insurer from reinsuring 100% of an authorized insurer's risks, as long as this activity does not allow the unauthorized insurer to engage in activities that would otherwise require it to obtain a license.<sup>66</sup>

One of the most avid critics of fronting has even considered that the practice should not necessarily be banned and noted that some fronting is useful.<sup>67</sup> Other experts acknowledge some of the benefits that fronting may bring.<sup>68</sup> Some authors have even qualified fronting as a consumer

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<sup>62</sup> See *Tharp v. Berdanier*, No. CIV.A. 21473, 2003 WL 22900646, at \*4 n.3 (Ohio Ct. App. Dec. 10, 2003).

<sup>63</sup> See OSTRAGER AND VYSKOCIL, *supra* note 29, at 1-28.

<sup>64</sup> Robert M. Hall, *Fronting and Direct Actions Against Reinsurers: The Final Chapter*, 1 (2008), <http://www.robertmhall.com/articles/FrontFinalChapArt.pdf>. (“Experienced insurance executives know that fronting carries with it significant business, regulatory and solvency concerns. It has been on and off the regulators’ radar screen for at least fifty years.”)

<sup>65</sup> See NEW YORK INS. DEP’T, *supra* note 7.

<sup>66</sup> *Id.*

<sup>67</sup> See Curiale, *supra* note 5 (“Does this mean regulators should ban the practice? Not necessarily; some fronting is useful and arguably should remain. Fronting can, in limited and defined instances offer a means by which all parties can achieve their goals in a cost-effective manner. For example fronting may be appropriate when statutory prohibitions serve to undercut an insurer’s longstanding relationship with its insured. This may occur when an insurer of a multistate firm lacks the requisite authority for writing particular lines in certain states or when an overseas insured opens a U.S. branch and seeks to retain its foreign-based insurer, especially when such insurer would qualify (and perhaps intends to apply) for licensure in the state in which the risks are resident.”).

<sup>68</sup> See, e.g., Hall, *supra* note 36 (“From a business standpoint, fronting has two benefits: (1) it allows reinsurers to run primary insurance programs without being

right, and considered that its elimination would not only be bad policy but would be an anti-consumer policy.<sup>69</sup>

### III. NEGATIVE OPINIONS AND REGULATORY CONCERNS

As much as fronting may have supporters of the practice, it does have a considerable number of opponents, especially among regulators.<sup>70</sup> The most common argument cited against fronting is that it enables an unauthorized carrier to circumvent existing statutes<sup>71</sup> and offer direct coverage without proper licensing. On the contrary, at least two authors consider this argument as “ironic” since a major reason of fronting is to

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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.”). But the author warns that “[w]hile 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.” *Id.*

<sup>69</sup> See Greene & Harkavy, *supra* note 8 (“Problems with definition aside, eliminating fronting is bad policy because it is anti-consumer. Fronting is not done to the policyholder; it is done for the policyholder. When an admitted carrier enters a fronting arrangement with a policyholder's captive, it does so at the behest of, and for the benefit of, that policyholder.”).

<sup>70</sup> See Hodson & Heath, *supra* note 45 (“While fronting is accepted as a necessary service for the success of captive insurers, it is not necessarily favored from a regulatory standpoint.”). See also Schiffer, *supra* note 35 (“In certain states, fronting is not looked at very favorably by insurance regulators.”); Vitkowsky & Ingersoll, *supra* note 9, at 417 (“While fronting transactions serve useful functions, insurance regulators believe that fronting transactions should be subject to careful scrutiny. There is great discomfort among regulators with the notion of unlicensed foreign and alien insurers using a licensed insurer to reinsure risks in the licensed insurer's state of domicile, when such foreign and alien insurers are not subject to state regulation.”).

<sup>71</sup> See Curiale, *supra* note 5 (“No matter how you slice it, fronting is a fiction designed to circumvent the existing insurance regulatory framework.”). See also Greene & Harkavy, *supra* note 8 (“Opponents view fronting as a method of circumventing state laws.”); JERRY & RICHMOND, *supra* note 3 (“Also, at times such [fronting] policies may be written for illegal or unethical purposes, such as for the purpose of evading state regulation or taxation.”); Hodson & Heath, *supra* note 45 (“When a company fronts business and then reinsures it 100 percent to a captive, a regulatory may see the transaction as a way to circumvent the licensing requirements of the state.”).

seek compliance with state laws relating to financial responsibility.<sup>72</sup> Another weakness in the circumventing argument is that it could be used against any conduct a regulator dislikes. For instance, a tax regulator could use a similar argument against customary tax advice. Thus, it must be recognized that as the market evolves into new practices, it usually dictates ways to legally conduct certain businesses, which may initially seem to circumvent the statutes but in the end result to be perfectly legal schemes.<sup>73</sup>

Very similar or at least related to this circumventing argument, is the notion that fronting aids and abets an unlicensed carrier to do business within a given jurisdiction.<sup>74</sup> In an opinion issued by the New York Insurance Department, about one year after the opinion cited in Section II above, the Department clearly stated its position that through fronting, a licensed insurer may illegally aid an unlicensed carrier.<sup>75</sup> The opinion states the following:

The Department is also concerned about the issue of fronting, which generally arises when a ceding insurer is 100% or substantially insured on a risk, by an unauthorized insurer. This situation occurs when unauthorized insurers, in order to avoid New York's statutory requirements, enter into reinsurance agreements with domestic companies who, in essence, act as fronting companies for the unauthorized insurers. Any arrangement or activity that would constitute the aiding of an unauthorized insurer would violate Section 2117 of the Insurance Law, and any authorized insurer that did any business that is equivalent to one of the specified types of insurance contained in N.Y. Ins. Law § 1101(b)(1) (McKinney Supp. 2005) in a manner designed to evade the provisions of the Insurance Law would be in violation of N.Y. Ins. Law § 1102 (McKinney

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<sup>72</sup> See Greene & Harkavy, *supra* note 8.

<sup>73</sup> As expressed by Allan Meltzer in the Wall Street Journal, "[t]he first principle of regulation is: Lawyers and politicians write rules; and markets develop ways to circumvent these rules without violating them." See Abramovsky, *supra* note 26, at 345.

<sup>74</sup> See Hall, *supra* note 36.

<sup>75</sup> See NEW YORK INS. DEP'T, REINSURANCE – PERCENTAGE OF RISKS RETAINED BY CEDING INSURER: LEGAL OPINION, (Jan. 6, 2006), <http://www.ins.state.ny.us/ogco2006/rg060105.htm>.

Supp. 2005). Each case would be evaluated on its own facts.<sup>76</sup>

At least one author has considered the aiding and abetting argument as “metaphorical” because most states have very precise rules on what activities by unauthorized insurers constitute doing business and fronting generally does not violate such rules.<sup>77</sup> One could also argue that if regulators wish to ban or regulate fronting, a precise and clear rule should be the way to do so, instead of relying on potentially ambiguous or questionable arguments.

Regulators have also expressed concern about the potentially fraudulent conduct that may be committed through the use of fronting.<sup>78</sup> Some arrangements may trick consumers into believing they are doing business with a sound insurer when in reality their insurance is being provided by an unfunded or unknown carrier.<sup>79</sup> Without a doubt, fronting would serve a dark purpose under this scenario. One could think of fronting as an ethical practice when chosen or at least known by the insured, but it certainly turns unethical when used with the intent to deceive the policyholder.

Another commonly cited concern of fronting is the potential solvency issue that may arise from its practice, as it could threaten the solvency of the ceding insurer.<sup>80</sup> This concern involves situations such as credit risks associated with fronting practice, potential insolvency of the fronting company, and even potential insolvency of the reinsurance or captive company. On this matter, it should first be noted that even when a fronting company cedes all of the risk associated with a policy, that company still remains liable to the direct insured for all of the associated

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<sup>76</sup> *Id.*

<sup>77</sup> See Hall, *supra* note 36.

<sup>78</sup> See OSTRAGER & VYSKOCIL, *supra* note 29, at 1-39.

<sup>79</sup> *Id.*

<sup>80</sup> Greene & Harkavy, *supra* note 8 (“First, some contend that fronting threatens the solvency of the ceding insurer. They argue that the ceding insurer is putting itself on the hook for risks it does not underwrite, since it simply passes the risk on to a reinsurer for a fee.”). But the author validly points out that “[i]f a regulator questions the security of fronted business, he or she has the power to deny credit for reinsurance to the ceding carrier in accordance with state laws . . . . The power to grant or deny credit for reinsurance is available to regulators for traditional reinsurance arrangements, and fronted transactions should be treated just like any other.” *Id.*

coverage.<sup>81</sup> Consequently, if the reinsurer becomes insolvent or there is a substantial coverage disagreement,<sup>82</sup> the fronting carrier will find itself in a very difficult position, since it will face the obligation to pay 100% of the ceded risks with a very small percentage of the premium.<sup>83</sup> For these reasons, a prudent fronting carrier should investigate its reinsurer's reputation and claims-handling practices,<sup>84</sup> and obtain appropriate collateral security.<sup>85</sup> Such collateral is useful not only to protect the company from the credit risk associated with potential failure by the reinsurer, but also to address the balance sheet impact of an unlicensed reinsurer on the fronting company due to the application of statutory accounting principles.<sup>86</sup> Although these measures do not solve the problem entirely, as the operations still carry associated risks, they do help reducing some of these risks.

Another complicated situation may be present in the event of insolvency of the fronting carrier. Absent a cut-through endorsement<sup>87</sup> and due to the highly probable presence of a standard insolvency clause<sup>88</sup> in the reinsurance agreement, if the fronting company goes insolvent, the reinsurance recoverable would probably be collected for the benefit of all policyholders of the front and not necessarily for any specific underlying insured. This would certainly destroy the original intent of the fronting program and would leave the insureds with no protection. As will be

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<sup>81</sup> See OSTRAGER & VYSKOCIL, *supra* note 29, at 1-26.

<sup>82</sup> Klaus Gebhardt, *Being Clear Up Front: There are More Areas of Potential Reinsurance Coverage Disputes Than You May Think*, BEST'S REVIEW, May 1, 2002 ("Apart from the obvious credit risk associated with ceding business to other insurance and reinsurance companies, the peril of fronting also may manifest itself in coverage disagreements.").

<sup>83</sup> See Hall, *supra* note 36.

<sup>84</sup> See OSTRAGER & VYSKOCIL, *supra* note 29, at 1-27.

<sup>85</sup> See William N. Curcio, *Putting up a Good Front*, BEST'S REVIEW, Oct. 2003, at 71, 74.

<sup>86</sup> *Id.*

<sup>87</sup> "A cut-through endorsement amends a reinsurance agreement by providing that, in the event of insurer insolvency, the reinsurer will pay reinsurance proceeds due to the insurer directly to the individual or entity named in the endorsement." See NAC REINSURANCE CORP., *supra* note 10, at 34.

<sup>88</sup> An insolvency clause will nearly be found in all reinsurance contracts due to statutory rules relating to credit for reinsurance, and will allow the liquidator of an insolvent insurer (normally the Commissioner of Insurance in a given state) to directly collect the reinsurance recoverable under reinsurance contracts for the benefit of all policyholders and creditors of the insolvent company. See NAC REINSURANCE CORP., *supra* note 10, at 29.

examined under Section V of this article, this situation could be solved if recent court rulings, that recognize a direct policyholder action against reinsurers of a fronting program, become adopted as standard case law for fronting practices.

#### IV. REGULATION OF FRONTING ARRANGEMENTS

Considering the regulatory concerns over the practice of fronting, there have been various proposals to regulate it which go back as far as the 1950's.<sup>89</sup> For example, in the 1970's and the 1980's, the New York Department of Insurance proposed a fronting regulation (Regulation 82) due to their ongoing concern about this practice, but the Regulation was never adopted.<sup>90</sup>

The National Association of Insurance Commissioners has also discussed proposals to regulate the practice, most notably the draft model acts entitled "Limitations on Reinsurance Activities of Insurers Model Act"<sup>91</sup> and the "Fronting Disclosure and Regulation Model Act".<sup>92</sup> These attempts, however, encountered severe opposition in the industry, due to the prevalence of using fronting arrangements for captives and other businesses.<sup>93</sup>

Despite such strong opposition from the industry, the NAIC adopted the "Fronting Disclosure and Regulation Model Act" in their

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<sup>89</sup> See Hall, *supra* note 36.

<sup>90</sup> See NEW YORK INS. DEP'T, *supra* note 7.

<sup>91</sup> Vitkowsky & Ingersoll, *supra* note 9, at 416.

<sup>92</sup> See Hall, *supra* note 36.

<sup>93</sup> See Vitkowsky & Ingersoll, *supra* note 9, at 417 ("An early 1992 exposure draft of the fronting model Act received a great deal of criticism from the insurance industry."). See also Greene & Harkavy, *supra* note 8, at 29 ("If the NAIC's draft model act were to become law, it would mean that policyholders would lose an important part of their ability to manage their own risks. No longer could captives be used to reinsure their parents' coverage. Risk managers would be unable to tap admitted reinsurance capacity and the excess and umbrella market. The NAIC draft would prohibit policyholders from using capacity for difficult-to-place risks which may not be available in the traditional market under acceptable terms. Risk managers would not even be permitted to designate the reinsurers on their own risks. In short, many responsible and well-established insurance programs would no longer exist.").

Winter National Meeting in December, 1993.<sup>94</sup> The purpose of the Act, as provided in its June 1993 Draft, is as follows:

The purpose of this Act is to ensure proper disclosure and regulation of reinsurance transactions in which an insurer domiciled in this state or, if the transaction covers risks resident in this state, an insurer licensed in this state, delegates to an unauthorized reinsurer underwriting or claim settlement authority, on business written directly by the licensed insurer or assumed from another licensed insurer.<sup>95</sup>

The Act later provides the requirement of prior regulatory approval for certain reinsurance transactions, most notably: a) when the annual gross written premium for business subject to the proposed transaction exceeds 5% of the insurer's statutory policyholder surplus, as reported in its most recent financial statement,<sup>96</sup> b) when annual gross written premium for the business subject to the transaction when added to all similar transactions is expected to exceed 15% of the insurer's statutory policyholder surplus, as reported in its most recent financial statement.<sup>97</sup>

Despite certain exemptions contemplated in the Act, the industry's opposition continued to be strong.<sup>98</sup> A sector of the industry considered the NAIC regulation not only as redundant but as impeding consumer access to alternative risk-transfer methods.<sup>99</sup> Moreover, it was alleged that the practical result of this regulation was to increase the costs of captive transactions because the additional burdens placed on the fronting carriers would be passed on to the captives.<sup>100</sup> It appears that the opposition was strong enough since the Model Act was not adopted by any state.<sup>101</sup>

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<sup>94</sup> See NAT'L ASS'N OF INS. COMM'RS, FOURTH QUARTER 1993 PROCEEDINGS 15 (Mar. 1995).

<sup>95</sup> See NAT'L ASS'N OF INS. COMM'RS, Third Quarter 1993 Proceedings, 665 (Nov. 1994).

<sup>96</sup> *Id.* at 666.

<sup>97</sup> *Id.* at 667.

<sup>98</sup> See Paul S. Brown, *Insurance Consumer Wary of Insurance Regulators*, ROUGH NOTES (Jan. 1, 1994), available at [http://findarticles.com/p/articles/mi\\_qa3615/is\\_199401/ai\\_n8726254](http://findarticles.com/p/articles/mi_qa3615/is_199401/ai_n8726254).

<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

<sup>101</sup> See Hall, *supra* note 36.

Despite the failure of the NAIC Model Act, certain states – most notably Florida<sup>102</sup> – have issued some form of regulation of fronting, either by statute, regulation, or bulletin. It has been noted,<sup>103</sup> however, that the number of states is very limited – only 17 states and the Virgin Islands – and that their regulation is either vague or overly broad.<sup>104</sup> Additionally and as previously mentioned, other states rely on the Aiding and Abetting statutes in an attempt to forbid the fronting practice.<sup>105</sup>

As noted above, fronting regulation has often failed to be precise or to even contain definitions of the forbidden practice. If regulators want proper regulation of fronting practices, a clear and precise language should be the norm. For example, such language could refer to the amount of risk retained by a fronting carrier<sup>106</sup> or the delegation of claims handling

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<sup>102</sup> Florida statutes forbid an authorized insurer to act as fronting company for an unauthorized insurer which is not an approved reinsurer. FLA. STAT. § 624.404(4)(b) (2004). The statute later defines fronting company as “an authorized insurer which by reinsurance or otherwise generally transfers more than 50 percent to one unauthorized insurer which does not meet the requirements of s. 624.610(3)(a), (b), or (c), or more than 75 percent to two or more unauthorized insurers which do not meet the requirements of s. 624.610(3)(a), (b), or (c), of the entire risk of loss on all of the insurance written by it in this state, or on one or more lines of insurance, on all of the business produced through one or more agents or agencies, or on all of the business from a designated geographical territory, without obtaining the prior approval of the office.”. *Id.*

<sup>103</sup> See Hall, *supra* note 36.

<sup>104</sup> See, e.g., MASS. GEN. LAWS ch. 175, § 193U (excludes fronting transaction from the definition of a medical malpractice insurer but fails to define fronting); VA. CODE ANN. § 38.2-2614 (2007) (also forbids fronting but fails to define it); V.I. CODE ANN. tit. 22, § 1695 (1993) (limits the scope of fronting regulation by defining a fronting company as “an insurer or ambulance service association which by reinsurance or otherwise, generally transfers to one or more unauthorized insurers or ambulance service associations, the risk of loss under ambulance service contracts written by it in the territory”); OKLA. STAT. tit. 36, § 6627 (also vaguely defines a fronting company as “an authorized insurer or licensed service warranty association which, by reinsurance or otherwise, generally transfers to one or more unauthorized insurers or unlicensed service warranty associations, the risk of loss under warranties written by the company in this state.”).

<sup>105</sup> See NEW YORK INS. DEP’T, *supra* note 75.

<sup>106</sup> See HODSON & HEATH, *supra* note 45. (“*The distinction between a ‘proper’ reinsurance transaction and an ‘improper’ fronting arrangement is perhaps found in the amount of risk retained by the fronting company and the purpose of the transaction. A regulator might question the legitimacy of a fronting arrangement if the purpose is solely to avoid a state’s licensing requirements and the entire amount of the risk is passed along by the fronting company.*”).

obligations. As explained above, however, strong industry opposition should be expected to any regulatory attempt to curtail fronting arrangements.

## V. COURT EXAMINATION OF FRONTING ARRANGEMENTS

Under typical reinsurance contracts and absent a specific cut-through endorsement, an underlying insurer does not have privity of contract with, or a right of direct action against, a reinsurer<sup>107</sup>, since the only contracting parties are the cedent and the reinsurer<sup>108</sup>. This situation also arises due to the indemnity nature of the reinsurance contract, which requires the cedent insurer to initially pay a claim in its entirety before demanding the reinsurance recoverable.<sup>109</sup> Moreover, when a cedent insurer becomes financially troubled and is subject to state insolvency laws, reinsurance recoverables are normally collected by the Insurance Commissioner, or the state official administering the insolvency, by enforcing the insolvency clauses that are commonly required by statutes in order for the cedent to obtain credit for reinsurance.<sup>110</sup>

Both of the situations mentioned above would typically cause an insured to fail in an attempt to sue a reinsurer directly. Some courts, however, are inclined to accept a direct claim from an insured to a reinsurer when the financially-troubled insurer merely acts as a fronting company rather than a true insurer<sup>111</sup>. In these cases, reinsurers have been held to the same standards as insurers when they act as insurers rather than reinsurers<sup>112</sup>.

For example, in 1959 the Supreme Court of Missouri, upon analyzing a typical fronting case, held in *O'Hare v. Pursell* that by taking over the complete risk, service of business, and other obligations, a reinsurer put itself in the position of a contracting party with the insureds.

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<sup>107</sup> See Johnson, *supra* note 23, at 250; see also *J.C.Penney Life Ins. Co v. Transit Casualty Company in Receivership*, 299 S.W.3d 668, 673-74 (Mo. Ct. App. 2009) (“Ordinarily, the original insured has no interest in the reinsurance. Indeed, a reinsurance contract ‘operates solely as between the reinsurer and the reinsured. It creates no privity between the original insured and the reinsurer.’ ... The reinsurer is ‘solely and exclusively’ liable to the reinsured and has no contractual obligation or liability to the original insured.”).

<sup>108</sup> See REINSURANCE ASSOCIATION OF AMERICA, *supra* note 21, at 9.

<sup>109</sup> *Id.*

<sup>110</sup> See, e.g., CONN. AGENCIES REGS. § 38a-88-10(a).

<sup>111</sup> See Johnson, *supra* note 23, at 250.

<sup>112</sup> See Hall, *supra* note 36, at 6.

The Court held that the law supplied the privity necessary for insureds to maintain a direct action against the reinsurer<sup>113</sup>. Similarly, in 1979, the Court of Appeals of Indiana held in *Foremost Life Insurance Company v. Department of Insurance* that consumers may proceed directly against reinsurers as third party beneficiaries where a reinsurer assumes responsibility directly to the policyholders<sup>114</sup>. The Court analyzed a reinsurance treaty where the reinsurer took 100% of the risks and assumed all administrative responsibilities of the policies.

In addition to these opinions, there are two fairly recent cases - both from Pennsylvania - that are very important to consider as part of any fronting analysis. A brief explanation of such cases follows:

A. *KOKEN V. LEGION*<sup>115</sup>

This case involved petitions for liquidation of Legion Insurance Company and of Villanova Insurance Company by the Pennsylvania Insurance Commissioner, M. Diane Koken. Both Villanova and Legion were rather sizeable fronting insurers that became insolvent despite significant funding efforts by their common parent company<sup>116</sup>. As part of the proceedings, several insureds who used Legion as part of their fronting programs, sought direct access to the respective reinsurance agreements in order to avoid the reinsurance proceeds from going to the insolvent estate for the benefit of all creditors, as advocated by the Commissioner.

These insureds were Pulte Homes, Inc., Psychiatrists Purchasing Group, Inc., American Airlines, Inc., and Rural/Metro Corporation. The court recognized that in the fronting programs of these insureds, the reinsurer not only bore 100% of the underlying risk but was directly chosen by the respective policyholders as part of their fronting programs.<sup>117</sup>

Despite strong opposition, the Court approved the Commissioner's petition to liquidate the companies, but, it also granted the petition of the insureds and gave them third-party beneficiary status with respect to the reinsurance agreements. In doing so, the court applied the *Guy*<sup>118</sup> test with

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<sup>113</sup> See *O'Hare v. Pursell*, 329 S.W.2d 614, 620 (Mo. 1959).

<sup>114</sup> See *Foremost Life Insurance Company v. Department of Insurance*, 395 N.E.2d 418 (Ind. App. 1979).

<sup>115</sup> See *Koken v. Legion Ins. Co.*, 831 A.2d 1196 (Pa. Commw. Ct. 2003).

<sup>116</sup> See *Simpson*, *supra* note 6, at 3.

<sup>117</sup> See *Koken*, 831 A.2d at 1241.

<sup>118</sup> *Id.* at 1237 ("In *Guy* [*Guy v. Liederbach*, 459 A.2d 744 (Pa. 1983)], our Supreme Court established a two-part test for determining third-party beneficiary status: (1) recognition of the beneficiary's right must be 'appropriate to effectuate

regard to the insureds' third-party beneficiary status, but clarified that direct access to reinsurance is a right to be established on a case-by-case basis. The court reasoned:

The Policyholder Intervenors all assert third-party beneficiary rights but on different factual grounds. The rights of Pulte, Rural/Metro and PPG stem from facultative reinsurance agreements specific to their individual risks; they were issued facultative certificates. American claims rights under a reinsurance agreement that is not strictly facultative, *i.e.*, a facultative obligatory treaty. On the other hand, the contract, or wording, between Legion and Syndicate 271 contains language that expresses American's right to cut-through Legion to collect reinsurance directly from Syndicate 271 [Footnote omitted]. In spite of the differences in their circumstances, all the Policyholder Intervenors can demonstrate third-party beneficiary status under the two-part *Guy* test.

First, it was the intention of the parties that the reinsurer assume all underwriting risk. Legion's only role was that of a fronting company, and the parties did not intend that Legion use the proceeds of the reinsurance for its general business purposes. Further, the reinsurance proceeds were used exclusively and entirely for the payment of Policyholder Intervenor claims, which satisfies the second part of the *Guy* test. Payment by the reinsurance companies was through Legion but for the benefit of the Policyholder Intervenors. In short, each "reinsurer" functioned as the direct insurer for each of the Policyholder Intervenors.<sup>119</sup>

Direct access to the reinsurance contracts was granted in these situations because the "true" insurer of the policyholders was actually the

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the intention of the parties,' and (2) contract performance must 'satisfy an obligation of the promisee to pay money to the beneficiary' or 'the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance.'").

<sup>119</sup> *Id.* at 1237.

reinsurer and not Legion. As clarified by the court, granting such a right must be analyzed on a case-by-case basis.<sup>120</sup>

B. *ARIO V. SWISS RE.*<sup>121</sup>

This case involved the parties' objections to a Referee's ruling on whether direct access to reinsurance should be allowed on fronting programs covering the insured's liability for workers compensation upon insolvency of the fronting carrier. Both parties, the Insurance Commissioner and the insured Tribune Company, considered the *Koken* case to be supportive of their positions. Tribune wanted direct access to certain reinsurance recoverables under fronting programs, but the Insurance Commissioner considered that Tribune had no such right, relying on the reasoning of the *Koken* case<sup>122</sup>.

According to the facts of the case, Tribune Company and Swiss Reinsurance entered into certain fronting programs for Tribune's workers' compensation exposure, using Reliance Insurance Company as a front. The first program, entitled Guaranteed Cost Program (GCP), provided that Reliance would insure and transfer certain workers' compensation liabilities to Swiss Reinsurance, subject to certain interim and aggregate limits. This meant that Reliance was left with potential excess liability. The second program, entitled Loss Portfolio Transfer (LPT), provided that Reliance would also insure and transfer certain workers' compensation liabilities to Swiss Reinsurance. However, this program differed due to the absence of significant caps and the presence of excess insurance by Tribune. As a result, Reliance was left with no real exposure and acting merely as a pass-through entity.

Because the transaction was not structured as an up-front arrangement and Reliance retained certain underwriting risk, the court upheld the Referee's ruling that Tribune should not have direct access to reinsurance related to the GCP program<sup>123</sup>. As for the LPT program, the court also upheld the Referee's ruling that Tribune should have direct access to reinsurance since the purpose of the transaction was simply a pass-through liability to Swiss Reinsurance.<sup>124</sup>

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<sup>120</sup> *Id.* at 1236.

<sup>121</sup> *Ario v. Swiss Reins Am. Corp.*, 940 A.2d 552 (Pa.Comm. Ct. 2007).

<sup>122</sup> *See id.* at 554.

<sup>123</sup> *Id.* at 556.

<sup>124</sup> *Id.* at 558.

The court identified several factors to be used in deciding whether an insurer should have direct access to reinsurance. The factors to be considered are: 1) did the insurer take on any underwriting risk or act as a front, 2) did the insurer enter into the transaction in order to generate fees, and not premium, 3) did the 'reinsurer' function as a 'direct insurer' for the policyholder and was the claims handling process and the funding of claims the responsibility of the reinsurer, 4) did the policyholder facilitate the reinsurer's involvement, 5) did the equities favor the policyholder's claim to direct access.<sup>125</sup> Although this test could provide a useful guide for fronting situations, the court did not clarify if all factors had to be satisfied or if the presence of some but not all factors would suffice.

By examining the previously cited cases and opinions, one could conclude that courts are recognizing direct policyholder actions against reinsurers when there is a clear fronting program. But until such rulings are adopted by the overwhelming majority of courts, it is reasonable to think that each case will be evaluated on its own facts and such evaluations will vary considerably depending on the jurisdiction.

## VI. CONCLUSION

By analyzing the above considerations and facts, several conclusions can be reached. First, fronting can be characterized as a legal risk-transfer mechanism, except where it is expressly prohibited or restricted. Although there has been an ongoing discussion on whether or not the practice of fronting circumvents existing statutes, there does not seem to be a strong argument against it and courts have generally considered these arrangements as legal. If a given state wants to forbid or regulate the practice, then a clear and precise set of express rules should be the norm.

Second, fronting is a helpful tool when properly used as it may enable a company to plan a successful captive program or an insurer to maintain its long-standing relationship with a client. As noted above, fronting has been considered an essential component for the survival of the captive industry and even its most avid critics believe that at least some form of fronting should be allowed.

Third, even though reinsurance contracts normally do not grant any privity rights to the underlying policyholders, it is unquestionable that courts have taken a more progressive approach when viewing the fronting practice and they have acknowledged the reality of the relationship

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<sup>125</sup> *Id.*

between the parties. Courts are moving towards recognizing policyholders' direct rights of action against reinsurers when the cedent insurer has only acted as a front and the reinsurer is acting as the true insurer.

Fourth, despite the above remarks, one cannot blind oneself from the negative implications and consequences that fronting can bring when used improperly. It is understandable why regulators are concerned with the practice of fronting. There have been abuses that resulted in insolvencies, potential fraud on policyholders, and evasion of state controls. In this sense, at least some regulation is necessary and helpful. For such regulation to be successful, however, a precise definition of the targeted practice is fundamental.<sup>126</sup> The construction of a definition should focus on the common elements of the practice in order to achieve that precision.

Given the diverse characteristics and widespread uses of fronting arrangements, one can conclude that state authorities have the option of regulating this practice through either a general or specific regulatory approach. A general approach would seek to regulate fronting as a general practice, either by prohibiting it or by limiting and regulating its use. Again, a precise definition is a mandatory component of such legislation. In contrast, a specific approach would seek to regulate the areas or fronting practices that cause specific concerns to a given regulator, without banning or restricting the practice in general. For example, a given regulator may not be concerned about all fronting practices, but may be alarmed by specific aspects or uses of it<sup>127</sup>. The determination of the potential aspects to be regulated, however, depends on the specific concerns of each jurisdiction.

As general conclusion, fronting is a valid, useful, and legal tool, except where expressly prohibited. Due to the negative consequences that fronting may also bring, at least some regulation establishing clear and precise guidelines would be appropriate; but, a general ban of the practice would not be convenient, especially for the captive industry. If a state chooses to regulate fronting, a specific regulatory approach would not only be more effective for compliance and enforcement purposes, but would probably be viewed more positively by the industry. Ultimately, this is a matter of state choice.

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<sup>126</sup> See HALL, *supra* note 36, at 3.

<sup>127</sup> For example, when fronting is used to deceive consumers.

