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## **The U.S. Captive Insurer Trend**

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### **New Challenges with Respect to Claims Cooperation & Notice**

There is a growing trend in the U.S. insurance markets to replace traditional commercial insurance with alternative risk transfer options, the most popular of which are captive insurance companies.

The number of captive insurance companies domiciled in the U.S. alone now exceeds 1,400 and captive insurance companies underwrite nearly all types of coverage for their parent companies. This trend has resulted in more than 50% of U.S. States enacting captive insurance company enabling statutes. The prospect of favorable tax treatment, the ability to tailor coverage to specific needs and directly access the reinsurance market, the reduction of operation costs, and the ability to exercise greater control over claims and claims management has resulted in approximately 80% of Fortune 500 companies and a large majority of the major U.S. corporations utilizing captive insurers for at least part of their commercial insurance needs.

The U.S. captive insurer trend, and to a lesser extent the increased use of “fronting” insurance policies, raises concerns regarding the cedent’s diligent and good faith handling of claims that may result in exposure under a reinsurance agreement. Unlike commercial insurers who have an independent interest in the proper handling of a claim, captive insurers and fronting insurers can be viewed as having no such independent interest and in some instances no true “risk.” Captive insurers are oftentimes controlled by the insured/parent company that, in some cases, control the claims handling and may have ulterior motives that can negatively affect the handling and settlement of claims. Fronting insurers pose a risk to reinsurers in that the lack of risk retention by a fronting insurer could lead to impassive claims handling.

Given this trend, a reinsurer’s rights under a reinsurance contract to prompt notification of claims and the cedent’s cooperation are of critical importance. U.S. courts have interpreted the follow-the-fortunes clause to afford reasonable latitude to cedents in the settlement and handling of claims, with limited exceptions under which a reinsurer can challenge a settlement. Therefore, reinsurers must be more diligent in enforcing their rights to notice and cooperation, including the right to associate in the defense of a claim and to obtain all relevant information and documents from the cedent. This is especially so with respect to claims and settlements tendered by cedents that are captive and fronting insurers. The alternative is that reinsurers presented with questionably-

handled claims and settlements from captive insurers and fronting insurers face the significant burden under U.S. law of challenging the settlement on the grounds that the captive insurer or fronting company failed to settle in good faith or on the ground that the loss falls outside the coverage afforded under the reinsurance agreement.

In this paper, we discuss the status of U.S. law regarding a cedent's obligation to provide timely notice to a reinsurer. More specifically, we discuss U.S. law as to when a cedent's duty to provide notice is triggered, as well as the majority rule requiring a reinsurer to establish prejudice as a result of late notice in order to avoid its obligations under the reinsurance agreement in the absence of language requiring timely notice as a condition precedent. We further discuss U.S. courts' interpretation of the claims cooperation clause, including a reinsurer's right to associate in the defense or control of a claim and its right to obtain information and records from the cedent so as to properly evaluate a reinsurance claim.

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