WILMERHALE

Life and Annuity Series: Captive Reinsurance Class Actions

JANUARY 25, 2015

There have been several new class actions filed recently challenging “shadow insurance” transactions between life insurance companies and their “captive reinsurers.” Three of those class actions are in federal court in New York (filed against Met Life and AXA). They allege specifically that life insurers violate Section 4226 of New York Insurance Law (which prohibits misrepresentations) when they reinsure or otherwise transfer risks on a block of life insurance or annuity business to an affiliated “captive” reinsurance company of the life insurer. The captive then obtains a letter of credit or similar collateral from a bank, which in turn is based on a guarantee or other financial commitment from the parent company of the life insurer, or some other affiliated company.

These “shadow insurance” transactions allegedly create a misleading appearance of transferring life or annuity risks to an independent insurance entity that is adequately capitalized, when in fact the risk is being cycled back to an affiliate of the life insurance company. According to the complaints, the transactions are not disclosed to potential policyholders, and also “manipulate[] the risk based capital ratio” that an insurer must accurately report, and artificially inflate[] the insurer's financial strength, to state insurance regulators, the SEC, Best's, and other ratings agencies. For support, the complaints rely on the June 2013 report by the New York State Department of Financial Services (“NYDFS”), which called these “shadow insurance” transactions “financial alchemy” that are a “shell game[] to hide risk and loosen reserve requirements,” and that “potentially [put] the stability of the broader financial system at risk.” These misrepresentations allegedly entitle all policyholders to recover, as a “statutory penalty,” all premiums that the life insurer received as a result of the misstatements, regardless of whether the policyholders suffered any damages.

Another complaint, against Fidelity & Guaranty Life in Missouri federal court, makes many of the same allegations, but from a much broader perspective under the NAIC accounting rules and reinsurance principles generally. It relies in part on an NAIC white paper in July 2013 stating that captive insurance companies should not be used to avoid statutory accounting, and that letters of credit issued to some captives are not “admitted assets” that would permit the underlying life insurance company to take a reinsurance credit. It claims damages under the federal RICO statute based on “overpayments” that annuity contract holders made for their products because the true financial condition of the life insurer was misrepresented to the public.

AXA moved to dismiss the class action complaint, arguing that section 4226 does not permit class action claims, but rather only individual claims by New York residents suing for their "own use and benefit." AXA also argued that the class could only include New York residents aggrieved under section 4226, and thus there was no subject matter jurisdiction in the SDNY under the Class Action Fairness Act. That motion to dismiss was denied by the court. Other defenses will include the obvious argument that there is nothing in the New York insurance law that prohibits captive reinsurance. Many, if not most, captive insurance transactions are reviewed and approved by a state regulator to ensure that commitments to policyholders are being met. Indeed, these transactions have been used for many years as important strategies for managing their risks and efficiently deploying capital, and have resulted in more competitive prices for consumers. Nevertheless, if these cases pick up steam, they could apply to many life insurance and annuity companies, and are worth watching carefully.