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S.D.N.Y. Dismisses Plaintiffs' "Shadow Insurance" Class Action Claims

Article By:

Max B. Chester

On July 21, 2015, a federal judge granted ***AXA Equitable Life Insurance Company'***s motion to dismiss claims brought against it by insureds who alleged that AXA violated New York law by engaging in various "shadow insurance" transactions. The Southern District of New York concluded that the plaintiff insureds failed to demonstrate that they had suffered a concrete injury-in-fact and therefore concluded that they could not satisfy the standing requirements of Article III of the Constitution. Thus, without subject-matter jurisdiction, the court dismissed the case. The decision is a positive bellwether for the life insurance industry, which has faced increasing scrutiny in recent months from regulators and the press regarding the propriety of certain captive reinsurance arrangements.

"Shadow Insurance"

The term "shadow insurance" has been used by various regulators, particularly in New York, to refer to the practice of using ***captive reinsurance companies,*** often domiciled in jurisdictions with relatively lenient capital reserve requirements, to transfer insurance risk off of the ceding insurer's books and allow the ceding insurer to free up assets for higher-return investments.

For example, suppose that Life Insurer A would like to increase its profitability by increasing its investment returns on its capital assets — i.e., the premiums that it has collected, a portion of which will ultimately be needed to satisfy insureds' claims. Life Insurer A sees that it can obtain greater returns through a certain investment that does not satisfy its state regulator's "admitted assets" rules governing Risk Based Capital ratios. In order to free up assets currently held in reserve, Life Insurer A's parent establishes Captive Reinsurer B in a jurisdiction with low reserve requirements, and the latter reinsures Life Insurer A. Through this captive reinsurance transaction, Life Insurer A reduces its exposure to future claims, allowing it to take a reserve credit toward the amount of assets that Life Insurer A's state regulator requires it to maintain in reserve.

On April 27, 2015, the *New York Department of Financial Services (DFS)* sent a letter to U.S. Senator Sherrod Brown to draw attention to what the DFS characterized as "shadow insurance" in the life insurance industry. DFS called these types of arrangements "financial alchemy" and "shell

games" that do not actually transfer risk away from the ceding insurer because, according to the DFS, in many instances, the only assets securing the captive's reinsurance commitments are parental guarantees issued by the ceding insurer's own parent company. DFS claimed that such captive reinsurance arrangements increased the likelihood that consumers' life insurers would become insolvent and unable to pay claims in the future, thereby creating systematic risk. It is worth noting, of course, that not all state regulators share New York's stance on the propriety of these arrangements. Some regulators have praised captive reinsurance arrangements as a way to deal with "redundant" capital reserve requirements.

Ross v. AXA Equitable Life Ins. Co.: The Lawsuit

Jonathan Ross and David Levin (Plaintiffs) brought a putative class action against AXA Equitable Life Insurance Company (AXA) for violations of New York Insurance Law § 4226. Section 4226 prohibits insurers from making any "misleading representation, or any misrepresentation of the financial condition of any such insurer or of the legal reserve system upon which it operates." Plaintiffs purchased AXA life insurance policies and in their lawsuit alleged that AXA filed annual disclosures that were misleading because the disclosures failed to disclose the details of AXA's captive reinsurance transactions, which allegedly created a false impression that AXA was healthier financially than it was in reality. Specifically, the complaint alleged that AXA misled consumers by failing to note that a sizeable portion of the letters of credit securing AXA's captive reinsurer's obligations to AXA were parental guarantees issued by the company's shared parent corporation.

District Judge Jesse M. Furman noted that Plaintiffs' complaint did not allege that these captive reinsurance transactions actually caused Plaintiffs any financial harm or that they relied on AXA's annual filings when they purchased life insurance policies from AXA. Instead, Plaintiffs had alleged that they themselves and the putative class members had "paid premiums for life insurance policies that are less financially secure than AXA represented them to be." Plaintiffs contended that they possessed an immediate statutory right to truthful financial reporting from their life insurer and that AXA's failure to describe its reinsurance arrangements had deprived them of that right.

The court focused the entirety of its analysis on Article III standing, ultimately concluding that Plaintiffs failed to demonstrate a constitutionally adequate injury-in-fact. While the court acknowledged the precedents cited by Plaintiffs for the proposition that Congress could enact statutes granting individuals' legal rights, thereby "clarifying" the injury that satisfies Article III requirements, the court called these precedents into question, citing to the Supreme Court's grant of certiorari in *Robins v. Spokeo, Inc*., No. 13-1339, 2014 WL 1802228, cert. granted, 135 S. Ct. 1892, 181 L. Ed. 762 (2015). Aside from the recent certiorari grant, Judge Furman also distinguished Plaintiffs' cases on the grounds that they dealt with legal rights created by Congress, rather than a state legislature, questioning the proposition that state governments could confer Article III jurisdiction to federal courts.

The Southern District of New York held that "a person's abstract interest in accurate information from an entity – without any actual or imminent injury arising from the entity's failure to disclose such information – does not constitute a 'concrete and particularized' injury sufficient to confer a right to sue in federal court." Additionally, the court rejected other arguments as to Plaintiffs' purported injuries on grounds of lack of causation, reliance, and imminence. While the court concluded by acknowledging the legitimacy of Plaintiffs' concerns about shadow insurance, it noted that such concerns did not relieve constitutional requirements and that other avenues of political and regulatory redress were available.

What the Decision Means

The decision in Ross is a victory for AXA and other life insurers facing similar claims of alleged impropriety regarding captive reinsurance practices at a time when such practices have drawn increased attention from regulators and the press. Judge Furman's decision in Ross will likely influence the outcome in another case pending in the Southern District of New York before District Judge Denise Cote, *Robainas et al v. Metropolitan Life Ins. Co*., Case No. 14-cv-9926, where plaintiffs alleged that the defendant's failure to disclose shadow insurance transactions constituted violations of New York Insurance Law § 4226.

Outside of New York, plaintiffs have challenged captive reinsurance transactions in life and annuities markets on RICO grounds, alleging, for example, that failures to adequately disclose the terms of these arrangements constitute predicate violations. See ***Silva v. Aviva Plc***, Case No. 3:15-cv-02665 (N.D. Cal.). The plaintiffs in *Silva* alleged that they suffered a concrete injury on the date that they purchased the policy by paying more for the policy than it was allegedly worth (an allegation that was missing in the complaint in *Ross*). The same counsel who represents the *Silva* plaintiffs proposed a similar class action against Fidelity & Guaranty Life Insurance (Fidelity) in the Western District of Missouri. See ***Ludwick v. Harbinger Group*****,** Case No. 4:15-cv-00011 (W.D. Mo.).

Motions to dismiss are currently pending in the *Robainas* and *Ludwick* cases and one is similarly expected in *Silva*. Whether these courts will find Judge Furman's reasoning on lack of injury and standing persuasive is unknown, but a worthy topic for life insurers engaged in captive reinsurance arrangements to keep an eye on.

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