

**UNITED STATES DISTRICT COURT  
SOUTHERN DISTRICT OF TEXAS  
HOUSTON DIVISION**

HOUSTON CASUALTY COMPANY,	§	
<i>Plaintiff,</i>	§	
	§	
vs.	§	CIVIL ACTION H-05-1804
	§	
LEXINGTON INSURANCE COMPANY,	§	
<i>Defendant.</i>	§	

**MEMORANDUM AND RECOMMENDATION**

This dispute concerning the applicability of Texas Insurance Code article 21.55<sup>1</sup> to a reinsurance claim is before the court on cross-motions for partial summary judgment (Dkt. 41, 44). Convinced that a reinsured’s claim for indemnity by its reinsurer is not a “first party claim” within the meaning of the statute, the court recommends that defendant Lexington Insurance Company’s motion be granted and plaintiff Houston Casualty Company’s motion be denied.

**Background**

The undisputed facts of this case are set forth in this court’s Memorandum and Recommendation issued June 15, 2006 (Dkt. 33), adopted by the district court July 11, 2006 (Dkt. 35), and will not be repeated in detail here. Briefly, HCC paid, pursuant to a reinsurance policy, Gulfstream Insurance’s \$786,636.00 claim arising out of property damage at the Universal Studios theme park in Florida. HCC then made a \$589,977.00 claim under

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<sup>1</sup> Article 21.55 was repealed in 2003 and recodified at §§ 542.051 through 542.061 of the Texas Insurance Code effective April 1, 2005.

its own reinsurance policy issued by Lexington. Lexington refused to pay the claim. The district court granted HCC summary judgment on its claim for coverage under the Lexington policy. *See* Dkt. 35.

The only matter yet to be resolved is HCC's claim that Lexington is subject to statutory penalties for violating the prompt payment provisions of Article 21.55. Both parties agree that there are no genuine issues of material fact, and that this claim hinges on issues of statutory interpretation appropriately resolved by summary judgment under FED. R. CIV. P. 56(c).

### **Analysis**

Lexington maintains that a reinsurance contract differs fundamentally from the type of insurance claim that article 21.55 was intended to regulate. Specifically, Lexington argues that two specific conditions for article 21.55 coverage are missing here: (a) HCC's reinsurance contract is not a "policy of insurance," and (b) HCC's reinsurance claim is not a "first party claim."<sup>2</sup>

Enacted by the Texas Legislature in 1991, the goal of article 21.55 is to obtain prompt payment of insurance claims, and to that end the statute must be liberally construed. TEX.

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<sup>2</sup> Lexington advances additional arguments in support of its motion: (i) that the legislative history of article 21.55 indicates that it is meant to protect consumers, not insurance companies like HCC; (ii) that article 21.55 cannot be given extraterritorial effect; and, alternatively, (iii) even if article 21.55 applies, Lexington's time for complying has not expired because HCC never provided "all items, statements, and forms reasonably requested and required" by Lexington. In light of the court's conclusion that HCC's claim is not a "first party claim," there is no need to reach Lexington's other arguments.

INS. CODE art. 21.55, § 8; *Wellisch v. United Servs. Auto. Ass'n*, 75 S.W.3d 53, 57 (Tex. App.–San Antonio 2002, pet denied). The statutory damages provision of article 21.55 provides:

In all cases where a claim is made pursuant to a policy of insurance and the insurer liable therefore is not in compliance with the requirements of this article, such insurer shall be liable to pay the holder of the policy or the beneficiary making a claim under the policy, in addition to the amount of the claim, 18 percent per annum of the amount of such claim as damages, together with reasonable attorney fees. If suit is filed, such attorney fees shall be taxed as part of the costs in the case.

TEX. INS. CODE art. 21.55, § 6. A “claim” is:

a first party claim made by an insured or a policyholder under an insurance policy or contract or by a beneficiary named in the policy or contract that must be paid by the insurer directly to the insured or beneficiary.

TEX. INS. CODE art. 21.55, § 1(3). Article 21.55 does not define “first party claim.” The time constraints for prompt payment are set out in article 21.55(3)(f):

Except as otherwise provided, if an insurer delays payment of a claim following its receipt of all items, statements, and forms reasonably requested and required, as provided under Section 2 of this article, for a period exceeding the period specified in other applicable statutes, or in the absence of any other specified period, for more than 60 days, the insurer shall pay damages and other items as provided for in Section 6 of this article.

Thus, article 21.55 imposes a statutory penalty of 18% for failure to pay a first party insurance claim within sixty days if an insurer is found liable under a policy, even if the insurer had a reasonable basis for denying coverage. *Performance Autoplex II Ltd. v. Mid-Continent Cas. Co.*, 322 F.3d 847, 861 (5th Cir. 2003); *Higgenbotham v. State Farm Mut. Auto. Ins. Co.*, 103 F.3d 456, 461 (5th Cir. 1997). “The sole basis for finding liability under

Article 21.55, then, is that the requisite time has passed and the insurer was ultimately found liable for the claim.” *Performance Autoplex*, 322 F.3d at 861.

**1. Is Reinsurance A “Policy of Insurance” Under Art. 21.55?**

Whether a reinsurance claim is subject to the prompt payment provisions of article 21.55 has not been addressed by reported decision of any state or federal court in Texas. Lexington maintains that a reinsurance contract is not a “policy of insurance” in any traditional sense, and relies most heavily upon a 1936 Texas Supreme Court decision discussing the nature of reinsurance in general:

Reinsurance contracts are not policies of insurance. Neither are they ‘contracts of insurance,’ as that term is generally understood. The parties to a contract of reinsurance are engaged in a kind of joint venture enterprise in the nature of a copartnership. By such a contract one insurance company does not insure the property of another insurance company, but only engages to indemnify it against liability upon its policies or contract issued to owners of property.

*Cunningham v. Republic Ins. Co.*, 94 S.W.2d 140, 142 (Tex. 1936).<sup>3</sup>

That discussion, however, was in the context of construing a statute which dealt with qualification bonds for fire insurance companies. Despite the general language of the quoted passage, it seems hazardous to impose the same reading upon a different statute passed by a different legislature for a different purpose 55 years later. This is especially true given the confusion which has surrounded the topic of reinsurance over the years. 14 ERIC MILLS

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<sup>3</sup> See also *Stradley v. Southwestern Life Ins. Co.*, 341 S.W.2d 195, 198 (Tex. Civ. App.–Dallas 1960, writ ref’d n.r.e.) (explaining that “reinsurance is a contract whereby, for a consideration, one agrees to indemnify another, wholly or in part, against loss or liability by reason of a risk the latter has assumed under a separate and original contract with a third party, the original insurer.”).

HOLMES, L. ANTHONY SUTIN, *HOLMES' APPLEMAN ON INSURANCE* 2D § 102.1 (2000) (“The term ‘reinsurance’ has been used by courts, attorneys, and textwriters with so little discrimination that much confusion has arisen as to what that term actually connotes.”).<sup>4</sup>

Reinsurance has been described as “insurance for insurance companies.”*Id.* This authority further explains the core idea of reinsurance as follows:

Properly used, reinsurance means one thing only—‘the ceding by one insurance company to another of all or a portion of its risks for a stipulated portion of the premium.’ In a true reinsurance transaction, the liability of the reinsurer is solely to the reinsured, which retains all contact with the original insured and handles all matters prior to and subsequent to loss.

*Id.* (footnotes omitted; quoting *Skandia America Reins. Corp. v. Schenck*, 441 F. Supp. 715, 724 (S.D.N.Y. 1977)).

Reinsurance facilitates the usual business of insurance in several important respects, such as enabling the reinsured to limit its liability on specific risks, stabilizing the loss experience of the reinsured, protecting against catastrophic loss, and increasing the capacity of the reinsured to write more coverage. *Id.* at § 102.2. Reinsurance also comes with its own parlance. The company purchasing reinsurance is referred to as the “ceding insurer,” the “cedent,” or the “reinsured.” The company selling reinsurance is generally known as the “reinsurer,” or sometimes the “assuming insurer.” If (as in this case) the reinsurer in turn seeks reinsurance for all or part of the risk it has assumed, the transaction is called a “retrocession,” and the second reinsurer is known as the “retrocessionaire.” *Id.* at § 102.1.

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<sup>4</sup> Reinsurance is to be distinguished from other forms of insurance such as coinsurance, double or multiple insurance, excess insurance, and substituted insurance. *Id.* at § 102.9.

Notwithstanding this specialized language, there appears little reason to regard reinsurance as anything other than a variant of a standard insurance policy. Review of the specific reinsurance contract in question confirms this conclusion. *See* Dkt. 41, Ex. A. The document, titled “Company Reinsurance Policy,” contains terms typically found in insurance policies. Its schedule sets out the premium, the policy limits (“sum reinsured”), the covered risks (“perils reinsured”), and the duration of the policy (“period of reinsurance”). The policy imposes upon Lexington the obligation to indemnify HCC against loss, a standard element of insurance contracts. *See* 1 APPLEMAN at § 3.1. (“Indemnity has been considered an essential element of a contract of insurance, so that a contract which does not possess this element is not one of insurance.”). The only departure from the norm is that the parties are designated as “reinsurer” and “reinsured,” in order to distinguish them from the parties to the original policy. The reinsurance contract clearly explains its relationship to those parties: the “reinsured” is defined as “Houston Casualty Company who in turn reinsure Gulfstream Insurance (Ireland) Limited, who in turn reinsure the Original Insured”; the “original insured” is defined as The Seagram Company Limited, Universal Studios, Inc., and their affiliated entities.

In sum, this reinsurance policy has all the essential features of a “policy of insurance,”<sup>5</sup> as that term is normally understood. The presence of additional features of

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<sup>5</sup> As noted in the court’s earlier opinion, this case involves facultative reinsurance, as opposed to treaty reinsurance, which is a blanket agreement to reinsure all policies issued by the reinsured which meet the criteria of the treaty. *See* 14 APPLEMAN at § 102.4 (referring to the (continued...))

reinsurance, by which a portion of the original risk is “ceded” to another insurer, does not transform the transaction into something other than an insurance policy, at least for purposes of Article 21.55. As HCC correctly observes, § 5 of Article 21.55 exempts certain insurance transactions from the purview of the statute. Reinsurance is not one of those exemptions. For these reasons, this reinsurance contract must be considered a “policy of insurance” under article 21.55.

Whether Article 21.55 was intended to apply to this type of *claim* under a policy of insurance is an altogether different question, to which we now turn.

## **2. Is HCC Making A “First Party Claim”?**

Article 21.55 by its own terms applies only to a “first party claim,” but supplies no definition of that phrase. Texas courts have described a first party claim as one in which an insured seeks recovery for the insured’s own loss. *Universe Life Ins. Co. v. Giles*, 950 S.W.2d 48, 53 n. 2 (Tex. 1997); *Lennar Corp. v. Great American Ins. Co.*, 200 S.W.3d 651, 702 (Tex. App.–Houston [14th Dist.] 2006, pet. filed). Property insurance is often cited as the quintessential example of first party insurance. *See Hartman v. St. Paul Fire and Marine Ins. Co.*, 55 F. Supp. 2d 600, 603 (N.D. Tex. 1998); *see also* BLACK’S LAW DICTIONARY 804 (7th ed. 1999) (defining “first party insurance” as “a policy that applies to oneself or one’s own property, such as life insurance, health insurance, disability insurance, and fire

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<sup>5</sup> (...continued)  
latter as a “contract *for* insurance,” while the former is a “contract *of* insurance”). No opinion is expressed concerning the applicability of article 21.55 to treaty reinsurance.

insurance.”). The insurance proceeds are paid by a first-party insurer directly to the insured to cover the insured’s actual, direct loss. *Lennar Corp.*, 200 S.W.3d at 703.

By contrast, a third-party claim is one in which an insured seeks coverage for injuries to a third party. *Giles*, 950 S.W.2d at 53 n.2. The insured will suffer a loss only if the third party reduces its claim to a judgment or settlement. In such a case the insured’s loss is “indirect,” while the third party’s loss is “direct.” *See* 1 APPLEMAN § 3.3. The payment of proceeds in practical effect runs directly to the third-party claimant, not to the insured. *Id.* Liability insurance is usually classified as a form of third party insurance. *Id.*; *Lennar Corp.*, 200 S.W.3d at 703.

Courts have addressed the scope of article 21.55's “first party claim” limitation in other contexts, such as a request for a defense<sup>6</sup> or a claim for indemnity under a commercial general liability policy.<sup>7</sup> No reported case has considered whether a reinsurance policy claim

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<sup>6</sup> There is a split among Texas state courts as to whether a demand for defense under a liability policy constitutes a first party claim. *Compare Northern Cty. Mut. Ins. Co. v. Davalos*, 84 S.W.3d 314 (Tex. App.—Corpus Christi, 2002), *rev'd on other grounds*, 140 S.W.3d 685 (Tex. 2004), *with TIG Ins. Co. v. Dallas Basketball Ltd.*, 129 S.W.3d 232 (Tex. App.—Dallas 2004, *pet. denied*). The Texas Supreme Court has accepted a certified question from the Fifth Circuit on the issue. *See Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 428 F.3d 193, 200-01 (5th Cir. 2005). Many federal district courts have held that article 21.55 applies to an insured’s claim for a defense. *See, e.g., Rx.Com Inc. v. Hartford Fire Ins. Co.*, 364 F. Supp. 2d 609, 612 and n.2 (S.D. Tex. 2005); *Meritage Corp. v. Clarendon Nat. Ins. Co.*, No. Civ. A. 3:03-CV-1439, 2004 WL 2254215 \*5 (N.D. Tex. Oct. 6, 2004) (finding that claim against reinsurer for defense was a first party claim); *but see Hartman v. St. Paul Fire and Marine Ins. Co.*, 55 F. Supp. 2d 600, 603-04 (N.D. Tex. 1998) (art. 21.55 remedy not available for breach of contractual duty to defend).

<sup>7</sup> *See, e.g., Lennar Corp.*, 200 S.W.3d at 702-04 (homebuilder’s claim for indemnity under a general liability policy is third party claim).

is a first party claim within the meaning of the prompt payment statute.<sup>8</sup> Nonetheless, considering the terms of this reinsurance policy in particular, as well as the nature of reinsurance in general, the court has little difficulty in concluding that HCC is making a third party claim beyond the reach of article 21.55.

HCC's assertion that it seeks recovery only for "its own actual, direct loss" is belied by the economic realities of the transaction. The "perils reinsured" by this policy belong not to HCC, but rather to the original insured, Seagram, which owned the Universal Studios theme park in Orlando:

All Risks of Physical Loss or Damage including Boiler Explosion and Machinery Breakdown, but excluding earthquake in Japan and California (but not excluding Insured perils ensuing therefrom).

*See* Dkt. 41, Ex. A, at 4. This was business interruption insurance for Seagram, not Seagram's insurers or reinsurers. The reinsurance policy simply transferred (or "ceded") a portion of Seagram's risk to other insurance companies beyond the original insurer. The actual loss incurred here is the interruption to Seagram's business, not HCC's.

As between Seagram and its original insurer (Gulfstream), Seagram's is a first party claim to be made whole for its own covered loss. But the reinsurers (HCC and Lexington) have no direct relationship to Seagram; although they underwrite a portion of Seagram's risk, they have no direct liability to Seagram; as to them, Seagram is a third party. The

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<sup>8</sup> The legislative history of this provision, cited in part by Lexington, is completely silent on the topic of reinsurance, and too general for useful guidance.

reinsurers' liability is part of a chain. Any reinsured's claim against another reinsurer is entirely derivative of the original insured's loss, and necessarily a third party claim.

Lexington's reinsurance policy by its own terms highlights the derivative nature of HCC's claim. The policy twice specifies Seagram as the "original insured" and lists the entire chain of reinsureds. Dkt. 41, Ex. A, at 1, 4. Perhaps more significantly, the policy schedule declares that its terms and conditions are "to follow the settlements of the Reinsured." *Id.* at 4. The follow-the-settlements doctrine provides that a reinsurer must indemnify its reinsured for payments the reinsured makes in settlement of claims against it without second-guessing the reinsured's liability determination. *See National Am. Ins. Co. of Cal. v Certain Underwriters at Lloyd's London*, 93 F.3d 529, 535 (9th Cir. 1996); *Houston Casualty Co. v. Certain Underwriters at Lloyd's London*, 51 F. Supp. 2d 789, 794 n.4 (S.D. Tex. 1999). In essence, the original loss simply passes through the reinsured to the reinsurer. HCC has already enjoyed the fruits of this doctrine, which was the basis for its successful breach of contract claim. *See* Dkt. 33. Having successfully invoked third party activity to prevail on that claim, HCC cannot fairly ignore the third party connections to this claim.

It is undoubtedly true, as HCC contends, that HCC incurred a loss by honoring the claim of its reinsured (Gulfstream). But out-of-pocket loss cannot be the sole test of a first party claim. If it were, all claims would be first party claims, and no distinction would be possible. The critical factor is whether the claim at issue originates with the claimant or with

another party. When the claimant merely seeks reimbursement for compensating another's loss, the claimant is pursuing a third party claim.

The parties devote much argument to the significance of the word “indemnify” in the policy, and whether an “indemnity policy” is properly classified as first-party insurance. This debate over a term not found in the statute is unproductive. As one noted treatise writer has observed, “the basis and foundation of all insurance law is ‘indemnity.’” 1 APPLEMAN at § 3.1. Indemnity is considered an essential element of any contract of insurance, although the indemnity principle may be “less pervasive” in some forms of insurance than in others. *Id.* For this reason, the Appleman treatise cautions that “although the characterization of insurance as an indemnity contract is useful as a statement of a tendency or as a generalization, it is not always a reliable guide when answers are sought to specific problems of insurance law.” *Id.* This advice seems sound, and will be followed here.<sup>9</sup>

As noted, the result reached here is not governed by any controlling precedent from the Texas Supreme Court, and constitutes an “*Erie* guess” about what Texas courts would do. *See Hodges v. Mack Trucks, Inc.*, 474 F.3d 188, 199 (5th Cir. 2006) (in making an “*Erie* guess,” a federal court attempts to predict how a state court would rule based on (1) decisions of the Texas Supreme Court in analogous cases; (2) the rationale and analyses

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<sup>9</sup> HCC cites a Fifth Circuit case for the proposition that indemnification claims under indemnity policies are first-party claims. *Medical Care America, Inc. v. National Union Fire Ins. Co.*, 341 F.3d 415, 425 (5th Cir. 2003). Actually, the *Medical Care* opinion merely assumed that proposition for purposes of argument, while affirming the dismissal of a claim under Texas Insurance Code article 21.21 [not 21.55] on other grounds. *Medical Care* has no bearing on the issue before the court.

underlying Texas Supreme Court decisions on related issues; (3) dicta by the Texas Supreme Court; (4) lower state court decisions; (5) the general rule on the question; (6) the rulings of courts of other states to which Texas courts look when formulating substantive law; and (7) other available sources, such as treatises and legal commentaries.). The result reached here is consistent with the holdings of Texas appellate decisions in analogous contexts. *See, e.g., Lennar Corp.*, 200 S.W.3d at 702-04 (homebuilder's request for indemnification under commercial general liability for damages paid to homeowners is a third party claim outside the scope of article 21.55); *American Nat. Fire Ins. Co. v. Hammer Trucking, Inc.*, No. 2-04-327-CV, 2006 WL 3247906 \*2 (Tex. App.–Fort Worth Nov. 9, 2006, pet. filed) (claim against excess insurer is not first party claim under 21.55). It is also in harmony not only with the language of this particular policy, but also with the general function of reinsurance as expressed in authoritative treatises. In short, this is the result the court believes the Texas Supreme Court would reach if presented with this question.

### **Conclusion**

For all these reasons, the court is persuaded that HCC's claim against Lexington pursuant to its policy of reinsurance is not a first party claim within the coverage of article 21.55. Therefore, the court recommends granting Lexington's motion (Dkt. 41), denying HCC's motion (Dkt. 44), and dismissing HCC's 21.55 claim with prejudice.

The parties have ten days from service of this Memorandum and Recommendation to file written objections. Failure to file timely objections will preclude appellate review of

factual findings or Lexington's objection is overruled. legal conclusions, except for plain error. *See* FED. R. CIV. P. 72.

Signed at Houston, Texas on June 25, 2007.

  
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Stephen Wm Smith  
United States Magistrate Judge