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Insurance-Rate Regulation-Construction and Effect of Guaranty Bond Agreement

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INSURANCE—RATE REGULATION—CONSTRUCTION AND EFFECT OF GUARANTY BOND AGREEMENT—Plaintiff, an insurance agents' association and several other insurance companies and associations, instituted an action attacking an order of the State Board of Insurance. The order approved a guaranty bond form, together with rates and rules, which had been submitted to the Board pursuant to statute[1] by the defendant insurance company.[2] The guaranty agreement was an arrangement whereby defendant guaranteed payment of losses under fire insurance policies of other insurers in the event the latter should be unable to pay. Although the bond form was not restricted to any specific original insurers, it was contemplated that defendant would use the guaranty arrangement in connection with the policies of its affiliate. Defendant was subject to regulated fire insurance rates, while its affiliate was not, even though both were under common management; thus, its affiliate was able to sell fire insurance at lower rates than those fixed by the Board for defendant.[3]

1 TEX. INS. CODE ANN., art. 5.13-.24 (1952).
2 The relevant portion of the bond form is set out in the principal case at 299.
3 TEX. INS. CODE ANN., art. 5.26 (1952).

Plaintiff objected to the guaranty agreement on the ground that it would, in effect, permit defendant to write fire insurance at unregulated rates. The lower court agreed and set aside the Board's order. On appeal, *held,* reversed, one judge dissenting. The guaranty agreement was a true guaranty bond, not a fire insurance policy, and thus was not subject to regulated rates. *International Serv. Ins. Co. v. Dallas Ass'n of Ins. Agents,* 351 S.W.2d 297 (Tex. Civ. App. 1961).

In a great many courts, at some time or another, there has been confusion in varying degrees over the use of the words "guaranty," "surety" and "reinsurance" when found in a common factual context. Often, a too-liberal interchange of these words and failure to make a careful distinction between them have caused the confusion. The Texas courts, however, seem to have recognized the fundamental technical distinctions. In a true guaranty situation, a guarantor promises to perform, or pay for the nonperformance of, an act which a third party is contractually bound to perform for the promisee; thus the guarantor's promise is contingent upon failure of performance by the third party.[4] A contract of suretyship is much the same as a guaranty, except that the surety is jointly liable on the third party's contract, while the guarantor is not.[5] Reinsurance, on the other hand, while it may resemble suretyship and guaranty in practical operation, is often wholly different in legal effect. In a contract of reinsurance, the reinsurer agrees to indemnify an original insurer for losses arising under the original insurer's policies.[6] The event which conditions the reinsurer's duty to pay is therefore the same contingency which gives rise to the reinsured's liability to the original insured. The rights of the original insured, however, depend upon the terms of the contract. If the contract is solely between the reinsurer and the original insurer, the original insured has no claim upon the reinsurer.[7] On the other hand, the contract of reinsurance may contain

4 Wood v. Canfield Paper Co., 117 Tex. 399, 5 S.W.2d 748 (1928); National City Bank v. Taylor, 293 S.W. 613 (Tex. Civ. App. 1927). See generally SIMPSON, SURETYSHIP § 6 (1950).

5 Arnett v. Simpson, 235 S.W. 982 (Tex. Civ. App. 1922); Farmers & Merchants Nat. Bank v. Lillard Milling Co., 210 S.W. 260 (Tex. Civ. App. 1919). See generally SIMPSON, SURETYSHIP §§ 5, 14 (1950).

6 Prudential Ins. Co. v. Associated Employers Lloyds, 250 S.W.2d 477 (Tex. Civ. App. 1952). *Accord,* Allemannia Ins. Co. v. Fireman's Ins. Co., 209 U.S. 326 (1908); Friend Bros., Inc. v. Seaboard Sur. Co., 316 Mass. 639, 56 N.E.2d 6 (1944). See generally 13 APPLEMAN, INSURANCE § 7681 (1943).

7 See Morrow v. Burlington Basket Co., 66 S.W.2d 746 (Tex. Civ. App. 1933); Southwestern Sur. Ins. Co. v. Stein Double Cushion Tire Co., 180 S.W. 1165 (Tex. Civ. App. 1915). *Accord,* Taggart v. Keim, 103 F.2d 194 (3d Cir. 1939) (agreement held not a guaranty because there was no privity between reinsurer and reinsured); Greenman v. General Reinsurance Corp., 237 App. Div. 648, 262 N.Y. Supp. 569, *aff'd without opinion,* 262 N.Y. 701, 188 N.E. 128 (1933). See generally 13 APPLEMAN, INSURANCE § 7694 (1943); VANCE, INSURANCE § 207, at 1071 (3d ed. 1951).

a specific provision binding the reinsurer to pay claims to policyholders of the original insurer, thus giving to the original insured a right to prosecute his claim against both.[8] A third type of contract may provide for a release of the original insurer subject to agreement by the original insured that he will accept the obligation of the reinsurer in return for his discharge of the original insurer.[9]

It is clear that the court properly analyzed the agreement in the principal case, in technical legal terms, and found it to be a guaranty arrangement. The defendant, as guarantor under the proposed agreement, was to become liable to the policyholders of its affiliate in the event that that company should become unable to pay. This was not a contract of reinsurance, because the contract was between defendant and the original insured, rather than between defendant and its affiliate.[10] Although it is true that certain reinsurance contracts may provide for rights and duties as between the reinsurer and the original insured,[11] the fact that reinsurance contemplates indemnification of the original insurer against losses under its policies would seem to deny the existence of such a contract where the original insurer is not a party. Nor was it a suretyship arrangement, since defendant was not jointly liable on its affiliate's insurance policies, but was liable only in the event that a final judgment rendered against its affiliate was not paid within thirty days. But here the analysis stops, with the court saying, in effect, that a finding that the agreement is a guaranty bond necessarily precludes any finding that the agreement might also be for fire insurance within the meaning of the statute providing for the regulation of fire insurance rates. Such a conclusion is not obligatory, however, especially in light of a general trend toward regarding many surety and guaranty agreements as contracts of insurance.[12] Mortgage guaranties and fidelity bonds are but two of the various types of agreements which have been held to constitute guaranty insurance.[13] And although guaranty insurance is not fire insurance in form, in this instance it is nevertheless fire insurance in practical effect.[14]

The leading Texas case to consider the relationship between a guaranty, or suretyship, and an insurance contract, held that a fidelity bond, although

8 See VANCE, *op. cit. supra* note 7, at 1071-73.

9 *Id.* at 1073-74.

10 See authorities cited notes 6, 7 *supra* and accompanying text.

11 See Vance, *op. cit. supra* note 7, at 1071-73, and text accompanying note 8 *supra.*

12 See 9 APPLEMAN, INSURANCE § 5273 (1943); 1 COUCH, INSURANCE 644-49 (2d ed. 1959).

13 *E.g.*, Bowers v. Lawyers Mortgage Co., 285 U.S. 182 (1932); United States v. Home Title Ins. Co., 285 U.S. 191 (1932); Young v. American Bonding Co., 228 Pa. 373, 77 Atl. 623 (1910); Town of Troy v. American Fid. Co., 120 Vt. 410, 143 A.2d 469 (1958). For an extensive list of cases, see Annots., 119 A.L.R. 1241 (1939); 100 A.L.R. 1449 (1936); 63 A.L.R. 711 (1929).

14 See VANCE, *op. cit. supra* note 7, § 197.

technically a surety arrangement, was in legal effect insurance.[15] A number of similar decisions have followed,[16] apparently guided by the principle that little, if any, weight should be given to the words used to characterize or classify the contract, and that the purpose and effect of the agreement should determine its legal consequences.[17] In the principal case, although the agreement was termed a "guaranty bond," the actual effect was to indemnify the original insured for any loss of money sustained due to default by the original insurer. The real question for the court, therefore, was whether such a promise to indemnify, when considered from the standpoint of its purpose and effect, was truly conditioned upon failure to perform by the original insurer, or whether it was actually contingent only upon a fire loss suffered by insured, so as to make the agreement subject to the regulated fire rates.[18]

There were several factors existing in this situation which might tend to show that the guaranty bond was in purpose and effect a form of fire insurance. First, and probably most significant, was the condition precedent to defendant's duty to pay. Although liability would attach if the original insurer, defendant's affiliate, was judicially declared to be insolvent or was placed in receivership, these conditions seem unimportant in light of the clause which provided that liability would attach if the original insurer should otherwise be found "unable to pay." Under the agreement, the original insurer would be deemed unable to pay if a final judgment rendered against it was not satisfied within thirty days.[19] It is plain that the original insurer could purposely defer payment for thirty days, even though perfectly able to pay, and thus bring into existence defendant's duty to pay.[20] The potential of such a scheme is obvious; it could, in practical effect, operate exactly as a fire insurance contract, at the whim and discretion of the parties. A second factor is

15 Southern Sur. Co. v. Austin, 17 S.W.2d 774 (Tex. Comm. App. 1929).

16 *E.g.*, Ware v. Heath, 237 S.W.2d 362 (Tex. Civ. App. 1951); Maryland Cas. Co. v. Crescent Valley Creamery, 103 S.W.2d 880 (Tex. Civ. App. 1937); National Auto Serv. Corp. v. State, 55 S.W.2d 209 (Tex. Civ. App. 1932).

17 "In determining whether a contract is one of suretyship or insurance, courts will consider the substance, rather than the form, of the contract. The fundamental nature of the contract cannot be changed by the names by which the parties may designate themselves." Southern Sur. Co. v. Austin, 17 S.W.2d 774, 776 (Tex. Comm. App. 1929).

18 As was stated in the dissenting opinion, principal case at 306, it seems clear that the legislature intended to distinguish between fire insurance and guaranty bonds. The portion of the Insurance Code which regulates guaranty bonds expressly excludes from its scope the writing of fire insurance. TEX. INS. CODE ANN., art. 5.13 (1952). This exclusion would also seem to evidence an intent to subject all fire insurance policies to the scrutiny of the rate regulation provisions, even though they are in the form of guaranty bonds.

19 See principal case at 299.

20 Indeed, as the dissenting judge stated: "No execution that I know of could be satisfied within thirty days after final judgment. The liability of [defendant] would attach before the ordinary execution could be satisfied." Principal case at 305.

that such a guaranty arrangement may act as a powerful inducement to insure with the unregulated companies whose performance the agreement was intended to guarantee. In the principal case, defendant's affiliate was an unregulated insurer of relatively small financial size. Thus, the fact that defendant's stronger financial position effectively guaranteed the obligations of the affiliate company might well encourage individuals to seek fire protection with the smaller, unregulated company. In addition to the lower rates offered by the unregulated affiliate, there would be the added inducement of financial stability and security which the guaranty of the larger company would provide.[21] A third consideration is the state attitude toward certain so-called contracts of reinsurance. Several years prior to the principal decision, defendant and other insurance companies had been reinsuring the policies of unregulated companies. Included in these contracts, however, was a provision giving the original insured a direct right of action againt the reinsurer. In response to a request by the State Board of Insurance for an opinion as to the legality of these agreements, the Attorney General of the State of Texas ruled that such contracts were illegal where the original insurer was issuing policies at rates lower than those to which the reinsurer was subject.[22] It seems clear that the purpose behind the guaranty bond in the principal case was to attempt to achieve the same result by means of little more than a change in nomenclature. It is difficult to comprehend how, when a contract entitled "reinsurance" is thought to be illegal, it may nevertheless be validated by a slight alteration of the merely formal effects of the contract and by changing the name to "guaranty bond." And this

21 Without the guaranty, the prospect of insuring with defendant's affiliate, Fort Worth Lloyds, would undoubtedly have been less attractive. In regard to certain highly desirable Federal Housing Authority contracts for which Fort Worth Lloyds was competing, the court said that an "order to meet claimed inadequacies in financial structure of certain deviators or unregulated companies caused Fort Worth Lloyds, an unregulated company as to fire rates, to secure financial backing of its affiliate, International Service [defendant], in providing . . . that its commitment on housing projects would be met." Principal case at 302. It is perhaps significant to note that at the end of 1957, approximately two years before the disputed application was filed, International Service had assets of $8,896,000 and surplus available to policyholders of $2,092,000 while Fort Worth Lloyds had assets of $625,000 and surplus of $452,000. ALFRED M. BEST CO., BEST'S INSURANCE GUIDE 119, 322 (1958). At the end of 1960, the assets of International Service were reported at $13,019,100 with surplus of $3,438,326. NATIONAL UNDERWRITER CO., ARGUS CASUALTY & SURETY CHART 36 (1961). In contrast, Fort Worth Lloyds wrote no insurance during 1960 and had assets of $655,080 and surplus of $637,581. NATIONAL UNDERWRITER CO., ARGUS FIRE CHART 91 (1961). These data would seem to support the conclusion that the financial structure of Fort Worth Lloyds was not suitable for an underwriting project of any magnitude, and that the relative affluence of International Service would provide a great inducement to insure with its weaker affiliate. On Lloyd's underwriters in general, see 2 COUCH, INSURANCE §§ 18:8-:10 (2d ed. 1959). Financial failures and increasing statutory restrictions have caused a virtual extinction of the Lloyd's association activities in the United States.

22 Principal case at 303.

difficulty is increased by the fact that the reinsurance contracts which were struck down by the Attorney General gave the original insured a direct right of action against the reinsurer.[23] Although perhaps technically reinsurance, they were little more than contracts of suretyship—arrangements so like those in the principal case as to admit of no significant practical distinction. Thus, although the soundness of the legal analysis which produced the finding that the arrangement was a guaranty is not to be questioned, the court failed to consider further the agreement in light of its purpose and effect. Perhaps the court felt it should defer to the findings of the State Board of Insurance which resulted in approval of the guaranty bond form,[24] and did not feel disposed to probe more deeply into the practical workings of the agreement in order to expose an incipient avoidance of insurance rate regulation. But if affiliated insurance organizations take full advantage of the opportunity afforded them by this decision, corrective legislation may become necessary.

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23 See authorities cited notes 7 and 8 *supra* and accompanying text.

24 See principal case at 302: "We do not believe that the Board was arbitrary and capricious in approving the filing . . . ."