REINSURANCE AND ASSUMPTION AGREEMENTS:

HOW DOES THE NOVATION TAKE PLACE?

By

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I. Introduction

In the parlance of the insurance industry a "reinsurance and assumption agreement" is the contractual vehicle by which a book of primary insurance business is moved from one primary insurer to another primary insurer. In fact, this transaction is a novation rather than a reinsurance transaction. As of a particular date, the insurer which takes over the book of business (the "assuming insurer") is substituted for the insurer which issued the policies (the "original insurer"). Typically, the original insurer pays the assuming insurer the unearned premiums as of the effective date of the transfer and the assuming insurer is responsible for claims occurring after such date. The original insurer retains the premium earned prior to the effective date as well as reinsurance, salvage and subrogation recoveries on losses which occurred prior to such date. New and renewal business is the responsibility of the assuming insurer. In effect, one primary insurer replaces another.

There are a number of reasons why reinsurance and assumption transactions take place. Sometimes insurers make a corporate decision to exit a line of business and this is one of the faster ways of doing so. The transactions also occur when an insurer, typically a life insurer, has encountered financial difficulties and the insurer, or its receiver, wishes to sell the book of business in order to raise liquid assets and preserve the value of the insured's accrued value in the policy. The specter of insolvency highlights the issue of policyholder consent to the novation. As the court observed in Vetter v. Security Continental Insurance Co., 567 N.W. 516 at 521 (Min. 1997):

Insurance policies are contracts and unless there are statutory provisions to the contrary, general principles of contract law apply. (Citation omitted) As a general rule, and in the absence of a contractual provision to the contrary, an obligor on a contract may assign all beneficial rights to another, or may delegate his or her duty to perform under the contract to another, without the consent of the obligee. (Citation omitted) Notwithstanding the assignment, however, the original obligor remains responsible for performance on the contract and if performance is substantially different from that required of the original obligor, the original obligor may be liable. (Citations omitted) In substance, *[sic]* original obligor may not divest itself of liability without the consent of the obligee. (Citations omitted) If the obligee consents to the delegation of duties, and agrees to release the original obligor from its responsibilities under the contract, a substitution of one party for another – or novation – occurs. (Citations omitted)[1]

The purpose of this article is to examine case law relating to reinsurance and assumption transactions to determine the circumstances under which an enforceable novation has taken place between the policyholder and the assuming insurer.

II. Novations When the Original Insurer is in Receivership

Most case law dealing with a novation as a result of a reinsurance and assumption transaction arises in the context of the original insurer being in receivership or subject to disciplinary action. In this context, approval of the assumption and reinsurance transaction by a court and/or the insurance department is a very significant factor in supporting the finding of a novation.

A. Cases Finding a Novation

A common fact situation in litigation over reinsurance and assumption agreements is an insured or beneficiary whose benefits under the coverage provided by the assuming insurer are less favorable, in one fashion or another, than the coverage provided by the original insurer. An example is Kuhl v. General American Life Ins. Co., 192 S.E. 831 (Ga.1937) in which a life insurance policy lapsed but the value of the policy was used to purchase term insurance. Pursuant to court order, and with insurance department approval, this business was reinsured and assumed by an insurer whose coverage granted term insurance for a lesser period. The insured died before the expiration of the original period but after the assuming insurer's period. The assuming reinsurer had sent the insured a certificate to attach to the policy noting the lesser period but the beneficiary claimed that the certificate was insufficient notice without the reinsurance and assumption agreement itself and that it should not be binding on her. The court disagreed stating:

The insured could not accept part of the certificate and reject others, and must be deemed to have accepted it according to its terms. The acceptance of this certificate by the insured bound him to the terms of the purchase agreement referred to therein, whether a copy was mailed to him or not. There is no allegation that any effort was made to obtain a copy of the agreement and the insured was at liberty to refuse to accept the certificate if a copy of the purchase agreement was withheld from him. The insured having retained the certificate in silence, his beneficiary will not now be heard to contend that the certificate and the purchase agreement did not constitute the agreement between the insured and the defendant.[2]

A case purporting to state the general rule in such matters is Jeffett v. American Ins. Co. of Texas, 280 S.W.2d 395 (Ark.1955). The insured was receiving disability payments when his insurer became insolvent and the book of business was reinsured by another insurer with insurance department approval. The insured received a certificate notifying him of the transfer and giving him the option of proceeding against the estate or receiving fewer monthly disability payments but did nothing until the disability payments ran out. The court ruled that a novation had taken place stating:

The general rule as to reinsurance contracts is that the reinsurer is to be held liable either under its reinsurance contract or upon a subsequent agreement made between it and the assured, and that *[sic]* assured has the right to accept the reinsurance offered him, or to sue the original company for damages. If he accepts the reinsurance contract and pays premiums to the reinsurance company, he is bound by the terms of the reinsurance contract, and cannot recover from the reinsurance company on the old policy unless the reinsurance contract in terms, or by necessary implication, contains an agreement to assume or be responsible on the policy reinsured.[3]

Kriss v. Bankers Life and Casualty Company, 335 P.2d 90 (Ok.1959) involved a benefit certificate issued by a mutual benefit association wherein the beneficiary paid an assessment on the death of other members. The benefit association became insolvent and with the approval of the insurance commissioner, the business was assumed by another insurer who billed on a monthly basis and which provided a certificate of assumption which contained notice of the assumption and sufficient information for the insured to calculate the limits available for the premiums paid. The book of business went through several additional reinsurance and assumption transactions before the insured died. The beneficiary sought the limits offered by the mutual benefit association which were higher than those offered by the assuming insurer.   The court rejected the beneficiary's arguments ruling:

Plaintiff further concludes that the named companies did not advise the insured of the terms of the reinsurance agreement and that therefore she is not bound thereby. As has been seen, the Commissioner of Insurance in 1937, under the provisions of (citation omitted) approved the sale of the defunct Damon Co. to the Santa Fe Co. That approval validated the reinsuring contract without more, under the record before us. The failure of the purchasing company to mail copies of the agreement to Damon policyholders did not invalidate that contract.[4]

Two much traveled policies were involved in Garretson v. Western Life Indemnity Co., 157 N.W. 160 (Iowa1916). One policy was reinsured and assumed six times after it was issued by a company that was placed in receivership and other was reinsured and assumed three time. At least the original transfers were approved by a court and the relevant insurance department. The insured received various riders to his policies and certificates subjecting coverage to the reinsurance and assumption agreement executed by the assuming reinsurers and the insured paid premiums to the assuming insurers. When one policy lapsed, he reinstated it with one of the assuming insurers. Under the circumstances, the court found that the original policies had been terminated, that the insured had accepted coverage from the assuming insurers and that the assuming insurers were not required to provide the level of benefits contained in the policy issued by the original insurer.

Green v. American Life and Accident Ins. Co., 112 S.W.2d 924 (Mo.Ct.App. 1938) involved two life policies which were issued by a company which became insolvent, were assuming by another company which became insolvent and then were assumed by the defendant. The transfers were pursuant to court order and with the assent of the relevant insurance departments. The insured understood that the policies were assumed and paid premiums to the assuming insurers. The insured received a notice from an assuming insurer that reduced the duration of term insurance that would be purchased should the insured default on his premium payments. The insured defaulted on premiums and then died after the term insurance purchased by the assuming insurer expired but before the date that the term insurance provided by the original insurer would have expired. The court ruled that the insured had elected to be insured with the assuming insurer and was bound by the terms and conditions of the coverage provided. The court went on to comment on the receivership context:

This is no case of a private reinsurance agreement entered into between two companies where the assent of the policyholders to any change would be required, but here the reinsurance agreement was entered into by virtue of a court order which was made in the course of the receivership proceeding in which all the policyholders were represented by the superintendent of the insurance department and by the result of which they were no less bound than if their names had appeared as actual parties to that suit. Once a policyholder elected to pay his premiums to defendant, the latter became liable to such policyholder, not, however, to the extent originally provided in the policy, but only to the extent of the liability it had assumed under the reinsurance contact. 5

Johnson v. American Life and Accident Ins. Co., 145 S.W. 2d 444 (Mo.Ct.App. 1941) re-examined the same reinsurance and assumption agreement as in the previous case. The agreement contained a provision placing a lien on the reserve value of the policy so that if the policy lapsed, the amount of term insurance that could be purchased was shortened in duration. The insured never received a copy of the reinsurance and assumption agreement but did pay premiums to the assuming insurer and reinstated the policy after it lapsed once. When the policy lapsed again, the insured died after the term insurance provided by the assuming insurer expired but before the term insurance under the original policy would have expired. In addition, there was a failure to comply with a state statute which required the assuming company to provide the insurance department with each insured's benefits pursuant to the reinsurance and assumption transaction and for the department to provide this to each insured. The court ruled that the statute was directory and not mandatory. In addition, the court ruled for the assuming insurer noting that the original policy was terminated by court order and that the insurance department had approved the assumption of business. Going further, the court stated:

[T]he rights of the policyholders, if they elected to continue their insurance with the reinsuring company instead of making a claim to their proportionate share of any assets of the insolvent company, were to be measured by the terms and provisions of such reinsurance agreement; and that the limitations upon the reinsuring company's liability, as fixed by the reinsurance agreement, did not depend upon proof of actual notice to the policyholders, whose election and consent to accept the same were to be taken as evidence by the fact of their payment of premiums to the reinsuring company.6

The insured received a new policy form, and paid premiums to, the assuming insurer after the insolvency of the original insurer in Western Life Indemnity Co., 145 N.E. 786 (Ind.Ct.App.1924). However, the new policy lapsed and the reinstatement rights were more liberal in the original policy than in the new one. The insured died after the interval to reinstate under the new policy expired. The court ruled: "When the appellee and her husband accepted the provisions of a new policy from appellant, the rights and liabilities of appellant and appellee were measured by the provisions of that contract and of the policy issued by appellant . . ."[7]

Two cases on a related subject involve objections by shareholders and policyholders in the receivership court to proposed reinsurance and assumption transactions. Neblett v. Carpenter, 305 U.S. 297 (1939); Ballou v. Davis, 75 F2d 138 (7th Cir.1935). In both cases, the recommended agreements were upheld. With respect to certain objecting policyholders, the Supreme Court noted: "The alternative open to all is to dissent from the plan and to prove their claims for breach of their policy contracts against the liquidator of the old company."[8]

B. Cases Finding No Novation

There are a few cases in which courts have found there to be no novation despite the approval of the transaction by a court and / or insurance department. One is Baer v. Associated Life Ins. Co., 248 Cal.Rptr. 236 (Ct.App.2nd Dist. 1988) in which the original insurer was given a cease and desist in California and entered into a reinsurance and assumption transaction with the assuming insurer pursuant to insurance department approval. The assuming insurer subsequently was placed in receivership. An insured of the original insurer received disability benefits from assuming insurer after the reinsurance and assumption transaction. When the assuming insurer was placed in receivership, the insurer sought to collect from the original insurer. The court ruled there was no consent to the novation on the part of the insured:

(The original insurer) contends that appellants submission of their claims to (the assuming insurer) is evidence of their approval of the Reinsurance and Assumption Agreement. However, it is clear that appellants were given no meaningful or effective alternative. They had no opportunity to object to the agreement before it was executed and approved by the insurance commissioner. Faced with the need for continuing and extensive medical treatment, appellants had no choice but to submit their claims for payment of medical benefit to (the assuming insurer). Their doing so does not reach the level of approval needed for us to find a novation.[9]

Another receivership case in which no novation was found is Protective Life Ins. Co v. Tibbs, 91 S.W.2d 593 (Ark.1936). When the original insurer was placed in receivership, the book of business was reinsured and assumed pursuant to court and insurance department approval. The reinsurance and assumption agreement granted the assuming reinsurer a lien against the reserve of the life policy subject to the lien being removed by payment of premium. The assuming insurer issued to the insured a rider to the policy which attached a copy of the reinsurance and assumption agreement. The insured declined to pay any further premium and when he died, his estate sought the face value of the policy. The court ruled in favor of the assuming insurer:

From construction of the contract of assumption it follows that appellee is not entitled to recover the face value of the policy of insurance from (the assuming insurer) because neither he nor the insured accepted the re-insurance plan by actually paying future premiums to appellant, but, on the contrary, repudiated the plan by refusing to pay such premiums.[10]

C. Comments on Novations When the Original Insurer is in Receivership

It is evident from the case law that courts examining the impact of a reinsurance and assumption transaction after the fact give considerable deference to an insurance department or receivership court which approves the transaction as the best means of salvaging for policyholders the value of their policies. Nonetheless, it would be wise for those effecting the transfer of a book of business from an original insurer which is in receivership to give insureds an explicit choice of: (a) making a claim in the estate for damages for breach of contract; or (b) accepting substitute coverage from the assuming insurer, with the coverage described in considerable detail. In addition, it is advisable to inform insureds that payment of premium to the assuming reinsurer or reinstatement or alteration of the coverage provided by the assuming insurer will be deemed acceptance of the transfer.

III. Novations Unrelated to Receivership of the Original Insurer

A. Cases Finding a Novation

The issue in Northwestern Nat. Life Ins. Co. v. Gray, 161 F. 488 (D.Neb.1908) was whether the insured could collect the face amount of the original policy from the assuming insurer. When the assuming insurer entered the assumption and reinsurance transaction, it provided the insured with notice of the transaction as well as notice that the face amount of his policy would be reduced. The insured continued to pay premiums until the policy matured. The court ruled in favor of novation holding:

Without hesitation, so far as this record discloses, and presumably with full knowledge of the provision made for him in the event he concluded not to accept the proposition, and with like full knowledge of the remedies available to him for the breach of his contract, (the insured) elected to accept and did accept the terms offered to him by the new company. He entered upon the performance and continued in the performance of the terms agreed upon for a period of 4.5 years until his certificate matured. This amounted to a novation, a new contract voluntarily entered into by (the insured), and he cannot now repudiate it. His election was final and conclusive.[11]

The assumption and reinsurance agreement did not allocate responsibility for deaths prior to the effective date of the agreement in American Public Life Ins. Co. v. Stambaugh, 456 S.W.2d 953 (Ct.Civ.App.Texas 1970). It appears, however, that the reserve liability for an individual who died prior to the effective date was part of the consideration paid to the assuming insurer. The court held that the assuming insurer was liable to the beneficiary stating:

Where . . . an insurer unqualifiedly assumes all obligations and liabilities of policies of insurance of another insuring company in exchange for a valuable consideration, then the insured may hold the assuming insurer liable under the terms and conditions of the policy so assumed. Where one company acquires funds from another for the specified purpose and agreement of payment of claims of designated policyholders, then no justification or reason exists for the assuming company to refuse payment to policyholders who had no knowledge of nor consented to the intercompany agreement.[12]

B. Cases Finding No Novation

Vetter v. Security Continental Ins. Co., 567 N.W.2d 516 (Min.1997) involved group annuity contracts issued to employee pension plans. Two related companies wished to transfer the book of business. After the transaction occurred, notice was given to the trustee of the pension plan that the transfer would be effected on payment of premium to the assuming insurer or within 20 days unless the contract holder objected. The trustee was not told that by not objecting, the original insurer would be released. The assuming insurer became insolvent and the trustee sought to collect from the original insurer. The court ruled that there was no novation since a state statute required that the original insurer remain liable for the default of the assuming insurer absent a written instrument, signed by the insured, releasing the original insurer.

In Barnes v. Helka Fire Ins. Co., 57 N..W. 314 (Min.1893) a policy was assumed by an insurer which later became insolvent after the insured suffered a fire loss. It does not appear that there was any agreement between the insurers or with the insured that the assuming insurer would be substituted for the original insurer. The court ruled that the insured could recover from the original insurer stating:

Unless there was a substitution of debtors, in the nature of a novation, between the three parties, upon the (insured's) consent to the new agreement, the (insured) has not waived or lost her right of action against the (original insurer). A creditor . . . may prosecute as many (remedies) as he has, as in the case of several debtors. And so, if, in this instance, the remedy against the insolvent company, as respects the plaintiff, was merely cumulative, there is no reason why she might not pursue both.13

The insured in Clair v American Bankers Ins. Co., 137 S.W.2d 969 (Ct.App.Mo.1940) received notice of the reinsurance and assumption and paid premiums to the assuming reinsurer before the policy lapsed for nonpayment of premium. While the court seemed skeptical that a novation had taken place, its consideration of this issue was pre-empted by its finding that the reinsurance and assumption agreement was not in compliance with state statute requiring advice to the insurance department which would provide an opportunity for objection by interested parties. Therefore, the agreement was ruled a nullity.

In Epland v. Meade Insurance Agency, 545 N.W.2d 401 (Ct.App.Min.1996), the court left to the jury the issue of whether a novation took place but the court's *dicta* suggests a high standard to prove a novation. The insureds had a hospital liability policy which was reinsured and assumed twice. After the first transaction, the insureds received notice of the transaction which contained a statement that payment of premium to the assuming insurer would release the original insurer. The insureds paid premium to the assuming insurer until the policy was reinsured and assumed again. The second assuming insurer gave notice of the transaction and directed the insureds to pay premiums to it. The insured failed to so pay premiums, since it was seeking another insurer, and the policy lapsed. When a loss occurred, the insureds tried to collect from the original insurer. Finding that novation was a matter of intent, the court found that this was an issue for the jury. However, the court commented:

Respondent insurance companies never sought or allowed for the (insureds') consent. They completed the sale of the policies and then informed the (insureds) they had new insurers. As far as the (insureds) knew, they had only one choice - pay the premiums or lose coverage.[14]

C. Comments on Novations Unrelated to Receivership of the Original Insurer

Without the supporting aura of an insurance department or receivership court approval of an assumption and reinsurance transaction, it is even more important to assure that insureds are informed consumers. They should be informed explicitly that they can: (a) reject the transfer (but be non-renewed at anniversary); or (b) accept the substitution of the assuming insurer which will provide the coverage described in some detail in the notice. In addition, insureds should be: (c) given a fixed amount of time to reject the transfer; and (d) informed that in the absence of explicit rejection of the transfer, that payment of premium to the assuming insurer or reinstatement or alternation of the assuming insurer's coverage will be deemed to constitute acceptance of the transfer.

IV. NAIC Assumption Reinsurance Model Act

Due to concerns about the transfer of books of business without policyholder consent, the National Association of Insurance Commissioners ("NAIC") adopted the Assumption Reinsurance Model Act ("Model Act") in 1993. According to the NAIC, similar legislation has been adopted in nine states and an additional seven states have related legislation in effect.

This Model Act excludes transactions with an insurer in receivership and also excludes those in which a guaranty association is a party, as long as policyholders do not lose rights or coverage.[15] All other transactions can be effected only with the prior insurance department approval which is based on a number of criteria listed in the Model Act, including the requirement that the assuming insurer be licensed in the states in which insureds reside.

All reinsurance and assumption transactions which are subject to the Model Act must meet very stringent standards to effect a novation with insureds. The Model Act requires explicit notice to insureds, such notice to include:

- Identification of the parties, relevant insurance departments supervising the transactions and contact people
- Procedures for accepting or rejecting the novation
- Five years of rating of both companies from two nationally recognized rating agencies
- Balance sheets for both companies for the last three years and the Management Discussion and Analysis for the previous year
- An explanation of the reasons for the transaction[16]

Policyholders have the right to reject the novation by returning a pre-addressed, postage paid card provided by the insurer. Policyholders have the right to pay premiums to the assuming insurer for 24 months but reserve the right to object to the transfer. At the end of 24 months, the assuming insurer can send a second notice and consent will be deemed unless the insured affirmatively rejects the transfer.[17]

The Model Act is well designed to protect policyholders from being involuntarily transferred to weak insurers. It does this, however, by making a reinsurance and assumption transaction less attractive as a means of moving a book of business between two solvent companies. The purpose of such transactions is to move business as of a particular date, to eliminate (or at least run off) administrative functions, to move unearned premiums reserves off the books and avoid reserving for losses after the transaction's effective date. Since the insurers involved may not know which insureds are transferred and which are not for over two years, accounting statement preparation and administrative functions are complicated and redundant. A sale of renewals becomes a more attractive, less regulated (albeit more attenuated) method to exit a book of business.

V. Conclusion

There is a surprisingly large number of cases dealing with the esoteric topic of reinsurance and assumption agreements. Most such cases arise when: (1) original insurer is insolvent, the assuming insurer alters coverage to make the product more viable financially and the insured does not understand that his or her coverage has changed: or (2) after the reinsurance and assumption transaction, the assuming insurer becomes insolvent and the insured wishes to collect from the original insurer.

In the first such situation, courts hearing such claims give considerable deference to the insurance department and receivership court in best trying to preserve the value the insureds' policies. Nonetheless, case law suggests that it is wise, at a minimum, to give the insureds a choice as to whether to make a claim against the estate or accept new coverage and to inform them that accepting new coverage is a substitution of the assuming insurer for the original insurer.

In the second situation above, there is no receivership court approving the transaction and insurance department may be unnecessary. As a result, it is wise to be even more explicit concerning the nature and impact of the transaction, to provide a limited period to object and to identify those acts which will be deemed to constitute acceptance of the substitute coverage offered by the assuming insurer.

To the extent that insurers contemplating the transfer of a book of business are subject to the NAIC Assumption Reinsurance Model Act or a close equivalent, they should consider a sale of renewals as a more practical alternative.

Endnotes

1. 567 N.W.2d 516 at 521.

2. 192 S.E. 831 at 833.

3. 280 S.W.2d 396 at 397 .

4. 335 P.2d 90 at 94.

5. 112 S.W.2d 924 at 928.

6. 145 S.W.2d 444 at 447.

7. 145 N.E. 786 at 792 - 3.

8. 305 U.S. 297 at 303.

9. 248 Cal.Rptr. 236 at 239.

10. 91 S.W.2d 593 at 596.

10. 161 F. 488 at 493.

11. 456 S.W.2d 953 at 955.

12. 545 N.W.2d 401 at 406.

13. 57 N.W. 314 at 315.

14. 545 N.W.2d at 407.

15. Model Act Sec. 2 B. (4) and (5).

16. Model Act Sec. 4.

17. Model Act Sec. 5.