GUARANTY ASSOCATIONS AND

REINSURANCE AND ASSUMPTION AGREEMENTS

By

Robert M. Hall

[*Mr. Hall is a former law firm partner, a former insurance and reinsurance company executive and acts as an insurance consultant as well as an arbitrator and mediator of insurance disputes. The views expressed in this article are those of the author and do not reflect the views of his clients.* *Questions or comments may be addressed to Mr. Hall at bob@robertmhall.com.*]

I. Introduction

In the parlance of the insurance industry, a "reinsurance and assumption agreement" is the contractual vehicle by which a primary book of insurance business is moved from one primary insurer to another. Such an agreement may or may not affect a novation *i.e.* a substitution of one insurer for another with the express or implied agreement of the insureds.[1]

If the transferee insurer becomes insolvent, guaranty associations may be called upon to pay the claims of the transferee's insureds. The purpose of this article is the explore case law concerning guaranty associations' obligations under these circumstances.

II. Case Law Finding the Guaranty Association Liable

In Mississippi Ins. Guaranty Assoc. v. MS Casualty Ins. Co. and American Reliable Ins. Co., 947 S.2d 865 (Miss. 2006) MS Casualty and American Reliable sought to exit the workers compensation business through reinsurance and assumption agreements with Legion. The insurance department approved the transaction and reinsurance proceeds on the business were assigned to Legion. Insureds were informed that Legion; (1) was their new insurer; (2) was the proper recipient of premiums; and (3) would pay their claims. However, the insureds were not asked to agree expressly to the substitution of insurers.

When Legion became insolvent, insureds made claims against the Mississippi Insurance Guaranty Association (hereinafter "MIGA"). The MIGA resisted arguing that these were not covered claims since Legion was a reinsurer.

The case turned on whether or not a novation had taken place. While there was no express assent by insureds to the substitution, the certificate of assumption sent to insureds described the transaction clearly and the insureds acted accordingly *i.e.* sending premiums and claim notices to Legion. The court ruled that this affected an implied assent which resulted in a novation.

An insurance department approved transfer of workers compensation business via assumption and reinsurance agreement from Selective to Reliance National provided the backdrop for Bowles v. BCJ Trucking Services, Inc. et al. 615 S.E.2d 724 (N.C. Ct. App. 2005). When Reliance National became insolvent, the North Carolina Insurance Guaranty Association (hereinafter "NCIGA") resisted claims on the basis that they were not "covered claims" under the guaranty association law. However, North Carolina Industrial Commission, which had original jurisdiction over the matter, ruled as a matter of fact that the transaction affected a novation and the NCIGA failed to take exception to this ruling. The court ruled against the NCIGA:

> As noted above, IGA failed to make exceptions to the Commission's findings of fact and they are binding on appeal. The Commission found as fact the assumption reinsurance agreement was a novation. It held the novation extinguished the contract between Selective and BCJ and that Reliance expressly assumed 100 per cent of Selective's obligations. The agreement did not create a new contract for insurance coverage but solely substituted a new party, Reliance for Selective, to the contract. Through novation, Reliance is deemed to have replaced Selective as if Reliance had issued the original contract of insurance to BCJ.[2]

III. Some Other Relevant Case Law[3]

A happier result, from the standpoint of guaranty associations, took place in Hemisphere National Bank v. Dist. of Columbia Ins. Guaranty Assoc., 412 A.2d 31 (D.C. Ct. App. 1980). A borrower obtained a loan secured by a surety bond. When the borrower defaulted on the loan, the bank negotiated for additional security in the form of deed of trust on land owned by the borrower. In subsequent litigation, the president of the lender admitted that the deed of trust was intended to replace the surety bond as security. The surety subsequently became insolvent and the lender filed a claim with the guaranty association. The court ruled against the lender on the basis that deed of trust affected a novation which terminated the surety's obligation and therefore, that of the guaranty association.

Security Benefit Life Ins. Co. v. FDIC, 804 F. Supp. 217 (D. Kan. 1992) involved a single premium deferred annuity issued to Hansen which assigned it to Savings Life which was liquidated by the FDIC. The obligation to pay the annuity was transferred several times through assumption and reinsurance agreements. Notice of the transfer was issued eventually to Hansen but did not make its way to the FDIC until long after the period stated in the notice to object to the transfer had passed. The FDIC sought to collect from the original issuer of the annuity. The court stated the applicable rule as follows:

> The assumption agreement was not effective as to Life Savings' successors in interest absent proof that at least one of them consented to the substitution. Unless [the original issuer of the annuity] can establish

> that . . . FDIC agreed to the substitution of [the successor insurer], the agreement between [the original issuer] and [the successor] cannot be construed as relieving [the original issuer] from its obligation on the Savings Life annuity.[4]

Since there was no evidence of consent, the court ruled that the original issuer remained liable to pay the annuity.

The original issuer, IAD, issued group annuity contracts to a trustee and then transferred the business to its subsidiary, IAI, pursuant to a reinsurance and assumption agreement in Vetter v. Security Continental Ins. Co., 567 N.W. 2d 516 (Minn. 1997). The trustee received an assumption certificate describing the transaction and providing an opportunity to object, but the certificate did not state that the trustee would lose its rights against IAD if it did not object. The trustee took no action at that time but when IAI became insolvent, sought to collect from IAD.

The court found that there had been no consent to the termination of the trustee's rights against IAD under either Minnesota or Illinois law. A Minnesota statute provides that an insured retains rights against the original insurer which engages in a reinsurance and assumption agreement absent written release signed by the insured. The court found that Illinois law has equally high standards on point.

IV. Conclusion

The upshot from the case law above is that an assumption and reinsurance transaction is not reinsurance but a transfer of book of business from one primary insurer to another. Therefore, the defense that reinsurance is not covered by guaranty associations is inapplicable.

However, not all reinsurance and assumption transactions result in a novation which cuts off the rights of the insured against the original insurer. Many states require high standards of proof to support a novation. When these issues arise, the efforts of guaranty associations could better be directed to proving a lack of novation so that the original insurer must pay the claims rather than the guaranty associations.

ENDNOTES

1 *See generally* Robert M. Hall, "Reinsurance and Assumption Agreements: How Does the Novation Take Place?" XI Mealey's Reins. Rpt. No. 24 at 20 (2001) (hereinafter "Hall"). This article may also be accessed at the author's website: robertmhall.com.

2 615 S.E.2d 724, 728 (internal citations omitted).

3 *See generally* Hall for an extensive treatment of case law concerning the facts under which a novation exists.

4 804 F. Supp. 217, 227.