TRANSFERRING BOOKS OF BUSINESS -

RECENT CASE LAW

By

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I. Introduction

Books of insurance business may be transferred for a variety of reasons, including the generation of revenue for the transferor insurer and cleaning the business out of an insurer to create a “clean shell” for sale. Two recent cases demonstrate both the pitfalls of the process and how it can be done successfully. Ironically, the author was an expert witness in both cases.

II. *J.C. Penney Life Ins. Co. v. Transit Casualty Co.,* 2009 Mo. App. Lexis 1378 (Ct. App. Mo.)[1]

As a prelude to the sale of Beneficial Fire & Casualty Company (hereinafter “Beneficial”) to J.C. Penney Life Insurance Company (hereinafter “Penney”), Beneficial entered into a “Reinsurance Agreement”, effective September 30, 1966, with Transit Casualty Company (hereinafter “Transit”). The Reinsurance Agreement contained provisions which had the following effect:

- 100% of the claims arising out of 12 classes of business were ceded by Beneficial to Transit with no exclusions.
- 100% of the unearned premiums were paid to Transit.
- Beneficial paid Transit 100% of its reserves for reported and unreported losses.
- Transit became responsible for the investigation, adjustment and defense of claims.
- Transit took over Beneficial’s assigned risk obligations.
- Beneficial assigned to Transit the right to collect premium from policyholders, reinsurance recoverables and subrogation and salvage.
- Transit agreed to pay taxes, boards and bureaus.

While the above characteristics strongly suggest a sale of the business on a non-recourse basis, the Reinsurance Agreement *did not* say that Transit was to become directly liable to policyholders. In addition, there is no evidence that Beneficial or Transit attempted to affect a novation with policyholders.[2]

Contemporaneous correspondence and documents suggest that Beneficial was intended to have no on-going liability on the business. The parties to the Reinsurance Agreement petitioned for and obtained the approval of the California Insurance Department noting that the intent of the transaction was to affect a withdrawal by Beneficial from doing business in California.

In 1985 Transit was placed in receivership. In 1992 Penney filed a proof of claim in the receivership for losses paid by Penney on business subject to the Reinsurance Agreement. The receiver classified the claim as a general creditor claim *i.e.* one that is very seldom paid. Penney objected to this arguing that its claim should receive a higher classification as a policyholder claim through subrogation.

The issues for determination, as characterized by the receiver, were whether the Reinsurance Agreement was a "contract of insurance or a reinsurance agreement" and, depending on the answer to that query, what creditor classification was appropriate.[3] A special master and the receivership court acknowledged that the Reinsurance Agreement contained some unusual terms but found that it did not expressly state that Transit was to be directly liable to policyholders and, as a result, it should be treated as Reinsurance Agreement and the general creditor status should be maintained.[4]

The court of appeals affirmed. Initially, it noted that the parties had agreed that the terms of the Reinsurance Contract were unambiguous so that extrinsic evidence did not need to be considered.[5] This eliminated consideration of illuminating contemporaneous documents about the intent and expected result of the transaction.

Second, the court observed that reinsurance is a contract of indemnity, ordinarily providing no rights to policyholders or other third parties. The court granted that a reinsurance agreement can give rights to third parties but to do so the "agreement must directly and clearly create third-party liability."[6] The court of appeals found that the Reinsurance Agreement did not clearly create such liability distinguishing on that point *O'Hare v. Pursell*, 329 S.W.2d 614 (Mo. 1959).[7]

III. ***G-I Holdings, Inc. v. Reliance Ins. Co. et al*, 2009 U.S. App. Lexis (3rd Cir.)**[8]

This was an appeal of a summary judgment ruling[9] in favor of Reliance Insurance Company (hereinafter "Reliance") and Hartford Fire Insurance Company (hereinafter "Hartford"). It involved the sale of a book of directors and officers book of business from Reliance to Hartford as Reliance was spiraling toward insolvency. Due, apparently, to the regulatory problems with novating the book to a new insurer,[10] the parties chose to make the transfer via a sale of "expirations" i.e. the renewals. In general terms, this meant reinsuring Reliance's net liabilities on existing business, taking over the servicing of the business and issuing Hartford policies when the Reliance policies expired.

The parties took a great deal of care in wording the relevant contracts. For instance, the Asset Purchase Agreement stated that Hartford was not assuming any liabilities of Reliance.[11] The Reinsurance Agreement stated that Hartford's obligations were limited to indemnifying Reliance for its ultimate net loss and that claims by policyholders were to be paid by Reliance and not by Hartford.[12] The Claim Servicing Agreements stated that Hartford did not substitute itself for Reliance as the insurer during the term of the Reliance policies.[13]

The relevant policy was a three year D&O policy which was cancelled by the insured after the first year, due to Reliance's financial difficulties, and renewed by Hartford. The same policy language was used by Hartford and the premium for the three year term was split with 80% going to Hartford which did not perform any additional underwriting. A combined liability cap for the Reliance and Hartford policies was added by endorsement.

A series of interrelated claims arose under the policies, the first during the term of the Reliance policy. The terms of the policies caused all such claims to fall under the Reliance policy and not the Hartford renewal. When the claims were asserted, Reliance was in liquidation so the insured argued that Hartford was its de facto insurer.

The court of appeal confirmed the lower court's summary judgment decision. Initially, it rejected G-I's argument that the Hartford policy encompassed the Reliance term of coverage. It found that: (a) this contradicted the plain language of the policies; (b) there was no expectation that the Hartford policy would encompass the Reliance term of coverage due to Reliance's financial difficulties;[14] and (c) the manner in which the Hartford policy was issued, priced or endorsed for the combined cap did not lead G-I to believe that Hartford was assuming Reliance's obligations.[15] Moreover, G-I's risk manager understood that these were two separate policies.[16] Finally, the court found the various contracts between Hartford and Reliance made it clear that Hartford was not assuming Reliance's liability to insureds.[17]

G-I drew an analogy to *Venetsano v. Zucker, Facher & Zucker*, 638 A.2d 1333 (N.J.Super.Ct. App.Div. 1994). In that case, an unauthorized insurer used a front company to issue the policy but controlled all aspects of the underwriting, premium collection and claim handling. The *G-I Holdings* court rejected this analogy on the basis that Hartford did not have the same level of control over Reliance and that there was no evidence of fronting.[18]

IV. Commentary

From a business standpoint, there is little question that the parties to the 1966 transaction in the *J.C. Penney* case were attempting to transfer a book of business in a manner that would create direct liability on the part of Transit Casualty. However, the court ruled to the contrary due to inadequate drafting of the Reinsurance Agreement, the court declination to consider extrinsic evidence and, probably, the court's reluctance to dilute assets available to policyholders by a subrogation claim by another insurer.

In contrast, the 2000 transaction between Reliance and Hartford in *G-I Holdings* was documented much more precisely as to the intent of the parties and the effect of the transaction on policyholders. That, plus the technique of transfer of the book of business (*i.e.* sale of expirations), produced the intended result. The moral of the story is that careful drafting of the relevant documents is very important to proper transfer of a book of business..

ENDNOTES

[1] This case appeared in the October 16, 2009 edition of Mealey's Reinsurance Reports at 13.
[2] For an extended examination of case law on reinsurance and assumption agreements and novations, *see* 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 is also available at the author's website: robertmhall.com.
[3] 2009 Mo. App. Lexis 1378*6.
[4] *Id.**7-8.
[5] *Id.**7.
[6] *Id.** 13.
[7] *Id.**13-17.
[8] This case appeared in the November 2, 2009 edition of Mealey's Reinsurance Reports at 12.
[9] The lower court decision is found at 2007 U.S. Dist. Lexis 19069 (D.N.J.).
[10] *See* Hall at § IV.
[11] 2007 Lexis U.S. Dist. 19069*11.
[12] *Id.**37-38.
[13] *Id.**41-42.
[14] 2009 U.S. App. 23488*11-13.
[15] *Id.**15-16.
[16] *Id.**14.
[17] *Id.**25-26.
[18] *Id.**29.