

INSURANCE ASSUMPTION TRANSACTIONS

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Transactions in which one insurer assumes liability for some or all of the insurance in force of another insurer are quite common. While often referred to as bulk or assumption “reinsurance” transactions, this terminology tends to blur the distinction between assumptions, where the assuming company becomes directly liable to the insured, and “true” indemnity reinsurance, where the assuming company is liable only to the ceding company.

There are various laws that might apply to an assumption transaction depending on the domiciles of the parties and the nature of the transaction. The main distinction with regard to the nature of the transaction is whether it is a simple assumption, or an assumption with a novation. A simple assumption is basically a two party transaction, in which the assuming company takes over the ceding company’s obligations under the assumed policies, but the ceding company remains liable to policyholders. An “assumption with novation” is a three party transaction in which the ceding company is relieved of its obligations to policyholders. Under the law, “novation” means that a new contract is formed to replace an existing one and, just as with formation of the original insurance contract, the new contract cannot be formed without the consent of both parties;¹ therefore, the insurer cannot unilaterally accomplish an assumption with a novation of the assumed policies.

For some time, the insurance industry did not distinguish between a simple assumption and an “assumption with novation.” Though the industry did not use this terminology, insurers assumed they could accomplish a novation without the consent of policyholders. This assumption was essentially unchallenged until assuming insurers started becoming insolvent. At that point, the ceding insurer’s responsibility for the assumed policies became a significant issue. Courts and regulators began questioning industry practices, and one result was the NAIC Assumption Reinsurance Model Act. This Act imposes fairly substantial obligations on both the ceding and assuming companies (though mainly on the former) in an assumption transaction, though it applies only when the parties intend to effect a novation. Other laws described below similarly apply only in this situation.

The heightened regulatory concern about and intrusion into “assumption with novation” transactions make them much more difficult to accomplish than simple assumptions. As noted above, the burdensome Assumption Reinsurance Model Act and other laws apply only when the parties seek a novation. More importantly, however, it is extremely unlikely that all or even a majority of policyholders will consent to a novation. While the lack of consent is usually due more to inertia than opposition to the assumption, it still leaves the ceding company with substantial contingent liability. And while the model act purports to *deem* that a policyholder has consented to a novation in some situations where there is no actual consent, which makes a novation much easier to obtain, there is some doubt about the validity of such “deemed” consent.

While it may be appropriate to ensure that any assumption with novation is based on the informed consent of the policyholder, it is also appropriate to protect the rights of the insurers to engage in simple assumption transactions without policyholder consent (and even in spite of policyholder opposition). As noted above, a simple assumption is a two party transaction that does not diminish the rights of the third party policyholder. The policyholder still has recourse against the ceding insurer but, after the transaction, also has recourse against the assuming insurer. In this situation, legitimate regulatory concern is quite limited. Therefore, provisions such as § 5A of the model act, which gives the policyholder the “right to reject the transfer and novation,” ought to be narrowly interpreted to prevent only the novation. Otherwise, regulators will simply force insurers to engage in an indemnity reinsurance transaction where the assuming company administers the policies, which results in less protection for policyholders.

Here is a summary of the laws that might apply to insurance assumption transactions:

Assumption Reinsurance Model Act. This model act, which has been adopted by only nine states, basically requires the ceding company to provide policyholders and agents with a large amount of information about itself, the assuming company, and the assumption transaction;² and states that a novation has occurred if the policyholder pays a premium after the notice or does not respond to a second notice two years later.³ As stated above, however, “[t]his Act does not

apply to [a]ny reinsurance agreement or transaction in which the ceding insurer continues to remain directly liable for its insurance obligations.”⁴ Thus, the fairly extensive requirements of the Act do not apply unless the ceding company is attempting to rid itself of all liability under the transferred policies (so that it is no longer liable for the policies, even if the assuming company fails to honor its obligations thereunder). When the model act does apply, each state which has adopted it, and in which an affected policyholder resides, would impose obligations on both the ceding and assuming companies.⁵

Bulk Reinsurance Laws. These longstanding provisions generally require regulatory filing and approval of bulk reinsurance arrangements, that is, reinsurance of all or substantially all of the insurer’s business in force and, in some cases, all or substantially all of a major class of such business. They do not distinguish between simple assumptions and assumptions with novation and, therefore, would presumably apply to both. Similar but separate statutes often exist for stock insurers and for mutuals. These laws generally apply only to a ceding company domiciled in a state which has adopted such a law.

Other Laws on Insurance Assumptions. Various other laws may apply to insurance assumption transactions. Some apply only to the state’s domestic insurers, while others apply to all insurers authorized to do business in that state. Likewise, some simply require a *filing* with the state’s regulatory authority; some require *approval* of the regulatory authority (though such approval may be deemed to have been given after passage of a certain amount of time after the filing); and some require *notice* to and *approval* of policyholders.

Examples of these miscellaneous provisions are the Wisconsin statutes which require an advance filing by any insurer authorized to do business in Wisconsin that proposes to cede reinsurance “other than in the normal and usual course of business,” and give the Commissioner power to disapprove the cession.⁶ A much less straightforward example is the California statute “hidden” in the law on insurer delinquencies, which permits the regulator to seek liquidation of a company that attempts to transfer “substantially its entire ... business” without a filing.⁷ A similar provision is part of the NAIC’s Insurers Rehabilitation and Liquidation Model Act,⁸ but the California version is unusual due to its broad application to domestic and nondomestic insurers, and the regulators’ broad interpretation of what constitutes “substantially” the “entire” business of an insurer.⁹

Disclosure of Material Transactions Model Act. Basically, this NAIC model act, which has been adopted by 47 states, would apply (1) only in the state of domicile of the ceding or assuming company;¹⁰ (2) only if the amount of assets being transferred with the policies crosses the reporting thresholds; (3) if the transfer of policies involved a material nonrenewal, cancellation or revision of ceded reinsurance;¹¹ and (4) only if the transaction has not otherwise been reported.¹² Thus, this model act has much more limited application in terms of the number of states that may be involved. It also imposes fewer requirements, which are generally limited to post-transaction reporting with no regulatory approval.¹³

Insurance Holding Company System Regulatory Act. The preacquisition notification (Form E) provisions of this model act, which have been adopted by 22 states, reference “bulk reinsurance” but should not apply to insurance assumption transactions. Under the model, a Form E is required when an authorized *nondomestic* insurer is acquired and certain market share thresholds are exceeded.¹⁴ However, “acquisition” is defined to mean “any agreement, arrangement or activity the consummation of which results in a person acquiring directly or indirectly the control of another person, and includes the acquisition of voting securities, the acquisition of assets, *bulk reinsurance* and mergers.”¹⁵

In light of this definition, the preacquisition notification rules seem to apply to a bulk reinsurance transaction, but only when the transaction results in an acquisition of control over an insurer. The problem, of course, is that it’s difficult to imagine how a bulk reinsurance transaction would result in such an acquisition of control and, therefore, why it is listed in the definition as an example of such an acquisition. Bulk reinsurance could be *part* of an acquisition transaction where, for example, it is combined with an asset acquisition, management agreement, acquisition of board of directors control, or some combination of these (though I have never seen such an acquisition) and, therefore, it is likely that bulk reinsurance was listed simply to cover the field of transactions that might be part of an acquisition of control. In any event, the definition clearly contemplates that preacquisition notification is not triggered without an acquisition of control and, therefore, it should apply to normal assumption transactions.

The regulatory and practical hurdles to an “assumption with novation” transaction probably means that such transactions will be rare. However, simple assumptions are likely to remain quite common. Insurers engaging in such a transaction should survey the laws of their domiciles and other affected states to determine their regulatory obligations.

Endnotes

1. See Frank J. Santry, “The Effect of Assumption Reinsurance on the Liability of the Ceding Insurer: A Survey,” FORC Quarterly Newsletter, Vol. V, Edition 4, December 3, 1993, and Ted F. Fay, “Assumption Reinsurance: A Time for Caution,” FORC Quarterly Newsletter, Vol. III, Edition 4, December 6, 1991.
2. Assumption Reinsurance Model Act § 4A.
3. *Id.* at § 5B and 5C.
4. *Id.* at § 2B(1). For a more detailed summary of the model act, see Phillip E. Allen, “Assumption Reinsurance Agreements,” FORC Quarterly Journal of Insurance Law & Regulation, Vol. XII, Edition I, March 11, 2000, and for some of its drafting history, see John Kezer, “Test Your Assumptions!” FORC Quarterly Newsletter, Vol. III, Edition 3, September 13, 1991.
5. *Id.* at § 2A.
6. Wis. Stat. §§ 611.78 (domestics) and 618.32 (nondomestics with respect to Wisconsin business).
7. Cal. Ins. Code § 1011(c).
8. Insurers Rehabilitation and Liquidation Model Act § 16L.
9. Richards D. Barger, “Section 1011(c) of the California Insurance Code: A Caveat,” FORC Quarterly Newsletter, Vol. V, Edition 3, September 17, 1993.
10. Disclosure of Material Transactions Model Act § 1A.
11. *Id.* at §§ 2A. and 3A.
12. *Id.* at § 1A.
13. *Id.* at § 1B.
14. Insurance Holding Company System Regulatory Act § 3.1C.
15. *Id.* at § 3.1A(1) (emphasis added).