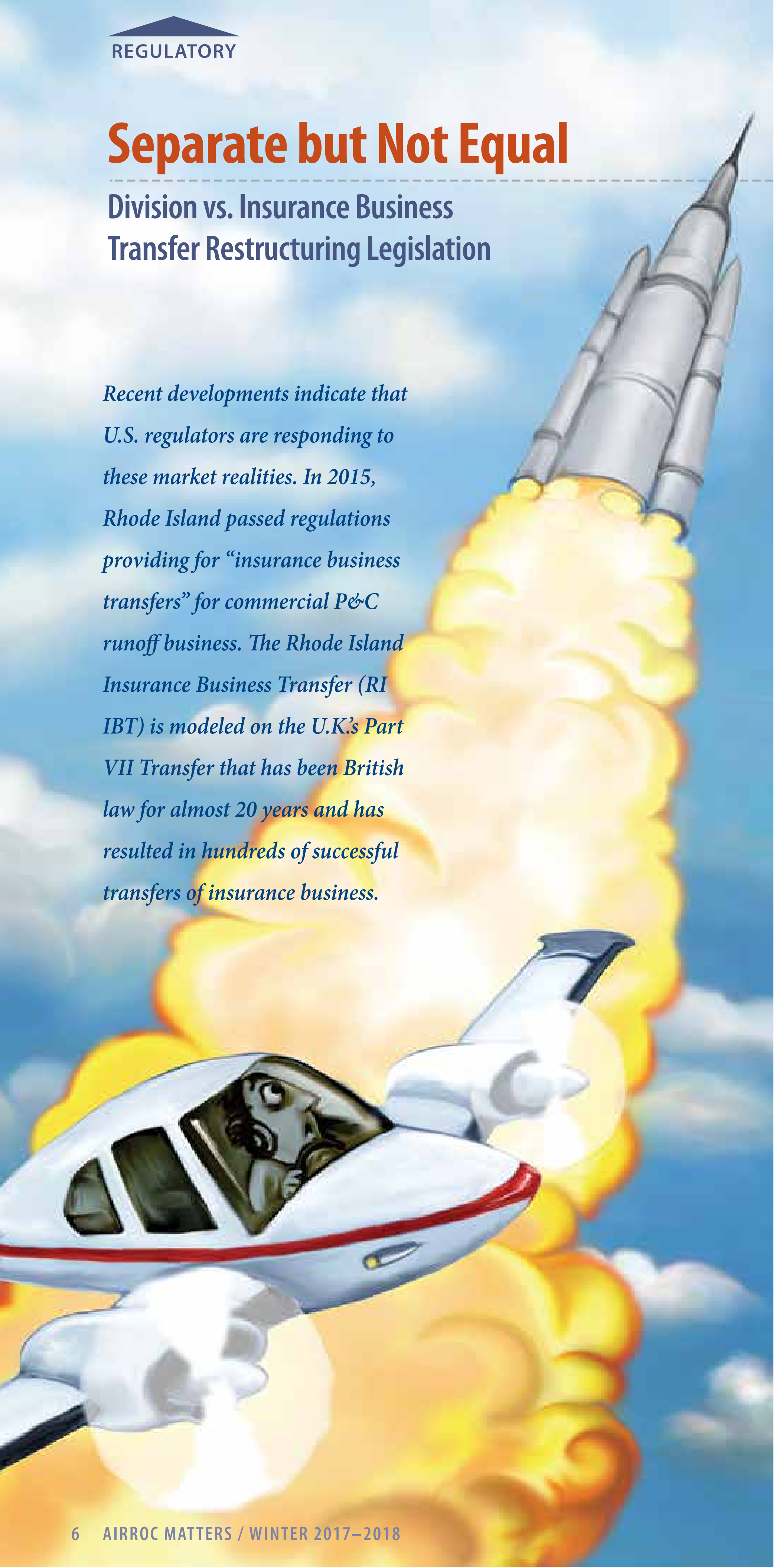
Separate but Not Equal

Division vs. Insurance Business Transfer Restructuring Legislation



Recent developments indicate that U.S. regulators are responding to these market realities. In 2015, Rhode Island passed regulations providing for "insurance business transfers" for commercial P&C runoff business. The Rhode Island Insurance Business Transfer (RI IBT) is modeled on the U.K.'s Part VII Transfer that has been British law for almost 20 years and has resulted in hundreds of successful transfers of insurance business.

The RI IBT is a court sanctioned novation of transferred policies from one carrier (that does not have to be a Rhode Island company) to another (that does have to be a Rhode Island company). Approval of an RI IBT is a multi-layered, transparent process that includes both regulatory and judicial review and approval. Like the U.K. Part VII transfer, the RI IBT results in a novation of the transferred policies, providing finality to the transferring company.

In May of 2017, the state of Connecticut passed Public Act 17-2 authorizing domestic insurers to divide. Hartford, a Connecticut domiciled carrier that is one of the state's largest employers, supported the law. The new statute allows a Connecticut domestic insurer to divide into two or more insurers and allocate assets and obligations, including insurance policies, to the new companies (i.e., new or resulting insurers). Resulting insurers are deemed legal successors to the dividing insurer and any assets and obligations are allocated to them as a result of succession and by direct or indirect transfer. Regulatory approval of the plan of division is required. A public hearing may take place, but no formal court approval is required. The commissioner must approve a plan of division unless (a) the interest of any policyholder or interest holder will not be adequately protected, or (b) the proposed division constitutes a fraudulent transfer. There is no requirement for policyholder approval.

While there are some similarities between the Connecticut division legislation and the RI IBT legislation, the differences in effect and application are striking.

Connecticut Division Statute

The Connecticut division statute is very similar to Pennsylvania's Business Corporations Law that also provides a procedure for companies to divide their business into separate entities. However, the Pennsylvania division statute has not enjoyed wide application. It was used once, in 1996, when the state insurance department approved a plan of restructure that placed all of ACE

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USA's Domestic Property and Casualty Insurance Group's runoff business within Century Indemnity Insurance Company, a subsidiary of Brandywine Holdings. Importantly, this transaction involved only commercial property and casualty liabilities. The process survived legal challenge, but, since then, no company has used the statute.

The Connecticut division statute requires minimal financial disclosure. The plan of division need only include "the manner of allocating [certain property] between or among the resulting insurers … the manner of distributing interests in the new insurers to the dividing insurer or its interest holders … and a reasonable description of policies or other liabilities, items of capital, surplus or other property the domestic insurer proposes to allocate to a resulting insurer." There is no independent review of financial information. A public hearing is at the discretion of the state insurance commissioner and there is no judicial review. The commissioner has the authority to approve a plan of division unless the commissioner finds that (a) the interest of any policyholder or interest holder will not be adequately protected, or (b) the proposed division constitutes a fraudulent transfer.

In the case of consumer lines of insurance such as long term care, a division statute like the one in Pennsylvania or Connecticut may not provide sufficient transparency and review requirements to ensure a successful transfer. The applicability of the division legislation to certain lines of insurance raises important questions regarding its utilization particularly as to policyholder protections and guaranty fund coverage. Asset adequacy and investments also are important issues. In addition, a company that considers taking advantage of the division statute needs to take into account state licensing requirements for the new company, notice to policyholders, and concerns about policyholder rights and protections.

Importantly, the CT division legislation was promoted by a company that seeks to use it for its variable life annuity business. Variable annuities involve a standard and recognized reserving process to determine the ultimate payout for the liabilities. Therefore, the variability in reserve outcomes should be minimal, and ultimately, the sales process between the buyer and the seller will determine whether more or fewer assets are necessary to consummate the transaction.

While the Connecticut division legislation may provide an option for variable annuities, there are other lines of insurance that can challenge its effective application. This is particularly so with long term care insurance, which involves an entirely different set of risks and considerations, including policyholder protections and rate increases. One of the key problems for the long term care industry is the high level of uncertainty associated with long term care reserves and the reserving practices the industry currently uses. In the case of a division, uncertainty about ultimate liabilities for long term care legacy liabilities likely will result in concern that the unknown exposure will be shifted to policyholders through future rate increases. In the case of variable annuities, the buyer or seller will absorb pricing risks, but in long term care there is a high probability that future experience variables will be borne by the policyholder in the form of rate increases.

An additional consideration is that the Connecticut division approval process is solely regulatory and whether the division would be enforceable in all relevant U.S. jurisdictions is unclear. Courts would apply the constitutional principle of full faith and credit if asked to examine whether the approval of the Connecticut Insurance Commissioner is enforceable outside of Connecticut. Article IV, Section 1 of the U.S. Constitution mandates that full faith and credit be given "in each State to the public acts, records, and judicial proceedings of every other state." It is unclear whether regulatory approval alone would be recognized and enforced in any other U.S. state without a court order.

Insurance Business Transfer (IBT)

In contrast, insurance business transfers (IBTs) are used worldwide and apply to all lines of business, both live and runoff. In the U.K. alone there have been hundreds of successful transfers, none of which have subsequently encountered financial difficulties.

Currently, Rhode Island is the only state that has legislation providing for IBTs. The RI IBT is a multi-layered transparent review process.

The IBT is a flexible restructuring tool. It can be used to combine similar business from two or more subsidiaries, putting all into a single company; to separate out different books of business, putting them into separate companies; or to transfer business between third parties. In contrast, the Connecticut division statute applies solely to Connecticut domestic companies, allowing them to separate business only within their corporate structure.

Currently, Rhode Island is the only state that has legislation providing for IBTs. The RI IBT is a multi-layered transparent review process. It requires notice to all policyholders and extensive financial disclosure by both the transferring and assuming companies. Both the regulator in the transferring company's home state and the RI regulator must approve the IBT plan. The review process also includes a report of an independent expert that must evaluate

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the impact of the transfer on all affected policyholders, including transferring and non-transferring policyholders and policyholders of the assuming company, if any. Because of this analysis, a resulting good bank/bad bank scenario is avoided.

There also is a court hearing, during which policyholders have the right to voice their concerns. If the court finds that policyholders are not materially adversely affected, then it will approve the IBT plan and implement a novation of the transferred policies. It is only after this multi-layered transparent review process that the transferring company is released from liability on the transferred policies. In short, the RI IBT is a proven business model with an approval process that is a carefully monitored, transparent review that balances the needs of all stakeholders to the transaction.

Currently, the RI IBT only applies to commercial P&C runoff liabilities. While the IBT review process far exceeds the Connecticut division legislation in terms of scope and effectiveness, the Rhode Island statute's restriction to P&C runoff does limit its application. There are ongoing discussions about potentially expanding the IBT to all lines of business.

Conclusion: The IBT shows real promise

Companies need restructuring tools that have wide application to address a changing business and regulatory environment. The Connecticut division statute does not have wide application and appears to be more a legislative response to the particular needs of an important local company. The IBT is a proven business model, having been used successfully worldwide as a restructuring tool for all lines of business. The experience of the U.K. runoff market has proven that a well-designed IBT process can be an effective restructuring tool for insurers and reinsurers. When and if Rhode Island (and/or another states) does adopt legislation that applies the IBT to all lines of business, then U.S. (re)insurers will have an effective, flexible restructuring tool with multiple safeguards to protect policyholder rights. ●

The opinions stated herein are those of the author and do not necessarily reflect those of Pricewaterhouse Coopers or its affiliates.

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