

# **Regulatory restructuring issues in reinsurance arbitration: A break-out session**

**ARIAS**

**May 9, 2019**

**The Breakers Hotel, Palm Beach, FL**

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# What We Will Discuss Today

- Overview
  - Traditional Exit Strategy Alternatives
  - Historic and Recent Restructuring Mechanisms
- Legacy Transaction Alternatives
  - EU Part VII
  - US Business Transfer Statutes
    - Rhode Island's Voluntary Restructuring Statute
    - Vermont's Legacy Insurance Management Act
    - Oklahoma's Business Transfer Act
  - US Business Division Statutes
    - Connecticut, Illinois and Michigan
  - Relative Merits of Statutory IBT/D
- Reinsurance Contract Clauses

# Introduction

## *Traditional Exit Strategy Alternatives*

Alternative	Considerations
Run off to expiration	<ul style="list-style-type: none"><li>• No legal (i.e., liability release) or financial finality</li><li>• Potential tail exposure &gt; 25 years</li><li>• Continued expense, distraction, potential reserve deterioration</li></ul>
Reinsurance	<ul style="list-style-type: none"><li>• Costly premiums</li><li>• Limited transfer of risk; continuing capital charge</li><li>• Potential loss of claims control</li></ul>
Sale	<ul style="list-style-type: none"><li>• Legal and financial finality if the subject business is novated or transitioned into a discrete legal entity</li><li>• Potential discount to net asset value</li></ul>

# *Statutory Restructuring Mechanisms*

## Historic Non-Insurance Specific Restructuring Mechanisms

- |                          |                                                                                             |
|--------------------------|---------------------------------------------------------------------------------------------|
| Arizona and Pennsylvania | • Entity Transactions Act allows companies to <b>divide business into separate entities</b> |
|--------------------------|---------------------------------------------------------------------------------------------|

## Historic Insurance Restructuring Mechanisms

- |                             |                                                                                                                                       |
|-----------------------------|---------------------------------------------------------------------------------------------------------------------------------------|
| Ins. Receivership Model Act | • Rehabilitation enables revitalization and reformulation; Liquidation allows insolvent companies to establish values to close estate |
| Assumption Reins. Model Act | • 9 states adopted; policyholders can accept or reject                                                                                |

## Recent and Emerging Restructuring Mechanisms

- |                              |                                                                           |
|------------------------------|---------------------------------------------------------------------------|
| RI ('15), VT ('14), OK ('18) | • Insurance Business Transfer effects <b>statutory novation</b>           |
| CT ('17), IL ('18), MI ('18) | • Insurance Business Division effects division <b>by operation of law</b> |

# Legacy Transaction Alternatives

## EU Business Transfers: *UK Part VII Transfer*

- Process under Part VII of the UK's Financial Services and Markets Act 2000
- Statutory novation of a portfolio of general and/or life insurance policies from one insurer to another
- A regulator and court-approved asset purchase agreement
- A/k/a insurance portfolio or business transfers throughout Europe
  - Ability to transfer associated assets and rights (outwards reinsurance, material service agreements and real estate) under court order, without counterparty consent;
  - Ancillary orders available, such as amending terms of policies (e.g., calculation of with-profits and references to sub-funds) and capital reductions
- UK process more onerous than other EEA processes – requires a scheme doc, independent actuary/expert, court approval.
- Policyholder safeguards: regulator fully participates, reports and appears in court; **notice**, and practical and proportional “communication strategy” **to** policyholders, other regulators and **reinsurers**; all **interested persons may appear and object**; transfer must be “fair” to all

# US Business Transfers: 1. *Rhode Island*

- “Voluntary Restructuring of Solvent Insurers” for Rhode Island commercial P&C domiciliaries
  - Regulatory and court processes terminate liabilities (via statutory novation), eliminate ongoing expense, and extract capital
  - Flexible segmentation of defined portfolio into separate cells or legal entities which can be sold to 3d parties
  - Commutation Plan yields finality with potential capital return
- **Notice to** insureds, **reinsurers**, interested government officials, NCIGF, NOLHGA, state GAs and GFs
- Court hearing; implementation order **enjoins all litigation** in all jurisdictions
- 2007 statutory and 2015 regulatory amendments allow for portfolio transfers to newly created or existing shell entities
- 2018 clarifying statutory amendments; added protected cells and “voluntary restructuring”
- If commutation plan, 2 court reviews (and possible appeal) with intervening **creditors meeting**

## US Business Transfers: 2. *Vermont*

- Vermont's Legacy Insurance Management Act, 8 V.S.A. Chapter 147 § 7111 – 7121 enables a non-admitted insurer from any jurisdiction to transfer **closed blocks** of **commercial P&C business** (no workers comp, health, life or personal) to a Vermont domiciled entity
- Solely a **novation** process; no regulatory mechanism to extinguish legacy liabilities
- Policyholders can opt out of the plan or be deemed to accept; **reinsurers can object per contract** terms
- Consent to jurisdiction in each state of policyholder residence
- Fees: \$30K, transfer tax = 1% of 1<sup>st</sup> \$100m of gross liabilities, .5% above that; DOI expenses
- Assuming co. not subject to guaranty fund law
- Appeal to VT S. Ct.

## US Business Transfers: 3. *Oklahoma*

- Okla. Stat. tit. 36, § 1681-8; modeled after Part VII
- Provides the “basis and procedures for the transfer and **statutory novation** of policies from a transferring insurer to an assuming insurer by way of an Insurance Business Transfer **without** the **affirmative consent of** policyholders or **reinsureds** . . . effected by court order”
- Regulatory and court (broad power) approval effect **release of transferor**
- Business that may be transferred:
  - “[A] policy, contract or certificate of insurance or a contract of reinsurance . . . and shall include **property, casualty, life, health, and any other line the Commissioner finds suitable**”
  - Does not distinguish between live or active contracts from discontinued or ‘run off’ insurance
- Notice to insureds, NCIGF, NOLHGA, state GAs
- Allows transfer to an Oklahoma-domiciled insurer, which “may be a protected cell company”
- Appeal/Review available



## US Business Division: 1. *Connecticut*

- Conn. Gen. Stat. § 38a-156r-z; no court action
- Domestic insurer w/an approved plan may **divide into 2 or more insurers** (may be LLP), resulting in (or not) the Dividing insurer and a new (or surviving) divided entity (the “Resulting insurer”) with allocated assets and obligations, including secured and contingent
- **Any line of business** may be transitioned
- Organic rules–required approval of governors and interest holder, and non-re/insurance, \$ contract–required consents apply
- Notice and public hearing if Commissioner deems them to be “in the public interest”
- Commissioner must approve unless any Policyholder or interest holder not adequately protected, or fraudulent transfer
- **Dividing insurer is released; Resulting insurers are liable for allocated liabilities as successors, not by transfer; reinsurer obligations not released or reduced**
- Liens, security interests & other charges on Dividing insurer property unimpaired
- **If division breaches Dividing insurer obligation, all Resulting insurers are liable jointly and severally**
- **Resulting insurer substitutes into any pending litigation**

## US Business Division: 2. *Illinois*

- 215 Ill. Comp. Stat. 5/35B-1 – 50; to stimulate economic development
- Division and allocation of a domestic stock company assets and liability **by operation of law**, not a distribution or transfer
- Article/bylaw-required approvals apply
- All lines of business may be transferred, including direct and assumed
- **“Reasonable” notice** required **if** Director deems to be in the public interest
- No policyholder opt out; **reinsurers bound, but division cannot expand or reduce the allocation and assignment of reinsurance**
- Dividing insurer released via **“final order not subject to further appeal”**
- Notice & public administrative hearing if Director deems it to be in the public interest *or* the Dividing insurer requests
- Director may reject plan that (i) does not protect policyholder or shareholder, (ii) Resulting co. not eligible for license, (iii) UFTA violation, (iv) purpose is to hinder, delay or defraud policyholders or creditors, (v) Resulting co. not solvent, (vi) Resulting co. assets unreasonably small IRO business & transactions
- **If division breaches Dividing insurer obligation, all Resulting insurers are liable jointly and severally**
- **Resulting insurer substitutes into any pending litigation**

## US Business Division: 3. *Michigan*

- Mich. Comp. Stat. §500.5500
- Division & allocation of a domestic stock company assets and liability **by operation of law**, not a transfer or assumption
- Article/bylaw–required board member & shareholder approvals apply
- Dividing co. must **notify reinsurers** w/i 10 business days of filing plan
- **No reinsurer obligation release or reduction; division cannot expand or reduce the allocation or effect an assignment or transfer of reinsurance**
- Many grounds for Director to reject a division plan
- Reasonable notice and public “contested case” administrative hearing; order with findings of fact & conclusions of law
- **Dividing co. “freed” via “final order, after relevant appeals exhausted”**
- **If division breaches Dividing insurer obligation, all Resulting insurers are liable jointly and severally**
- **Resulting insurer substitutes into any pending litigation**

# *Points for IBD/T*

- Foreign and domestic owners of active re/insurers or those running off, under supervision or in receivership can offload entire portfolios or discrete lines of legacy liabilities w/finality
- Regulators can improve the financial condition of active and discontinued business
- Uncommitted/redundant capital can be reinvested
- Policyholders avoid receivership and receive their bargain benefit
- Guaranty funds are consulted but not triggered
- No estimation or acceleration issues
- Full transparency and fair disclosure of information
- Regulatory (and judicial) supervision
- Time limited challenges
- Responsive to new international equivalence and cooperation

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# *Against*

- Reputational risk for Dividing insurers
- Diminished confidence in the industry
- Eliminates reinsurer consent/approval, may violate anti-assignment contract clauses
- Potential division of treaty counterparty
- Effect on set-offs?
- May not comply with Dodd Frank §531(b) – Credit for Reinsurance
- Novation to a single(?) state licensed carrier impacts Guaranty Fund & Association protection
- May force counterparties to accept a commutation plan (RI; NY)
- Potential Due Process challenge?
- Potential Contracts Clause challenge?
- Application of other state laws (*e.g.*, CO) and/or objections/review by other state regulators?
- Approval order entitled to Full Faith and Credit?

# Non-Assignability

- This Agreement shall be binding upon the Parties hereto, together with their respective successors. None of the Parties hereto may assign any of their rights or obligations under this Agreement without the prior written consent of the other Parties.
- Forced commutation?

# Termination

- This Agreement may be terminated:
- After thirty (30) days written notice by any Party in the event that the Company or the Reinsurer amalgamates with or passes under the control of any other company or corporation or changes a majority of its officers or board of directors during the term of this Agreement.
- This Agreement provides for termination on a [run-off vs. cut-off] basis. The relevant provisions of this Agreement shall apply to the business being [run-off/cut-off] and shall survive the termination of this Agreement.
- *Ipso facto?*

## Setoff (Statutory – DE)

- “In all cases of mutual debts or mutual credits between the insurer and another person in connection with any action or proceeding under this chapter, such credits and debts shall be set off and the balance only shall be allowed or paid....”
- Exceptions:
  - The obligation of the insurer to such person would not at the date of the entry of any liquidation order or otherwise, as provided in § 5924 of this title, entitle such person to share as a claimant in the assets of the insurer; or
  - The obligation of the insurer to such person was purchased or transferred to such person with a view of its being used as an offset;
- 18 *Del. C.* § 5927(a). (*OR* NY 7427)

# Other Clauses

- Business Covered (“Agreement solely between the Company and the Reinsurer”)
- Sliding Scale Commission
- Salvage
- Commutation
- Confidentiality
- Access to Records
- Progressive Dispute Resolution/Arbitration
- Amendments
- Notice
- Governing Law
- Signature



# *Thank You !*

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