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New Beginnings: U.S. Regulation is Generating More Flexibility for Transactional and Legacy Deals – The Who, What, Where, Why and How of Insurance Division and Business Transfer Laws

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I. Introduction

In recent years, several U.S. states have enacted insurance business transfer legislation or promulgated regulations meant to approximate the effect of Part VII of the U.K. Financial Services and Markets Act 2000, which allows an insurer to transfer its business, or a book of business, to another entity without the need for individual policyholder consent (a "Transfer Law").

Separately, a few other U.S. states, beginning with Connecticut, have taken a step in the direction of corporate reorganization by allowing an insurer to divide into separate companies (a "Division Law"). Similar to a demerger carried out as a scheme of arrangement under the U.K.'s Companies Act of 1982, a transaction effected under a Division Law can be viewed as the reverse of a merger.

In recent years, there has been an acceleration of activity related to insurance business transfer laws and insurance company division laws, with the passage of the Insurance Business Transfer Act in Oklahoma following implementation of similar laws in Rhode Island and Vermont, and the passage of Division Laws in Illinois, Michigan, Iowa and Georgia that closely follow the Connecticut model. Currently, similar legislation has also been introduced in a handful of additional states.[1] Amid interest and questions from the industry, the National Association of Insurance Commissioners ("NAIC") is studying these laws and developing a white paper with proposed best practices. In addition, the National Council of Insurance Legislators ("NCOIL") is proposing an Insurance Business Transfer Model Act based on Oklahoma's Insurance Business Transfer Act. ACLI has also developed principles and guidelines with respect to these laws.

Transfer Laws and Division Laws are new tools for insurers to manage blocks of insurance business, to transfer business in the case of Transfer Laws or to create more transformative corporate reorganizations in the case of Division Laws. We are starting to see the evolution of Transfer Laws with respect to the types of business that may be transferred, approval requirements from state insurance regulators or courts, and policyholder objection or "opt out" rights. While the enacted insurance company Division Laws and Transfer Laws vary, we have noticed a trend of standardization of the regulatory review process, *e.g.*, the NAIC working groups and ACLI's principles and guidelines. This outline provides an overview of these regimes and discusses key considerations for companies interested in pursuing a transfer or division and regulators evaluating these transactions.

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[1] As of the date of this outline, at least one other state, Nebraska, is currently considering legislation to enact a Division Law similar to that of Connecticut, Illinois, Michigan, Iowa and Georgia. Nebraska Legislative Bill 602.

II. Background—Insurance Business Transfers in Europe and Company Division in the U.S.

A. As part of the development of a single European market, in the early 1990s, EU member states were required to allow insurers to transfer portfolios to/from insurers in other EU countries. The approach to such transfers varies among EU countries, but the process is generally subject to safeguards to protect policyholders. EU member states are required to recognize the effectiveness of a business transfer undertaken pursuant to another member state's rules.

B. The UK adopted these rules by amending its Insurance Companies Act 1982 to introduce the concept of "Schedule 2C" transfer. An overhaul of UK financial services legislation in 2001 and 2002 renamed the concept as a "Part VII Transfer." A Part VII Transfer is a "statutory novation" process to replace one on-risk (re)insurer with another, subject to court approval and a finding that there will be no material detriment to any involved policyholders. The use of a Part VII Transfer scheme is <u>mandatory</u> for insurance business transfers (*i.e.* the novation of anything more than a few insurance policies must follow the regime).

C. In the U.S., there is some historical precedent for Division Laws as well.

1. Pennsylvania originally adopted a corporate division law (applicable to business entities generally) in 1988.[2] This statute was used by CIGNA in 1996 to divide one of its insurance subsidiaries to isolate asbestos liability. The Pennsylvania statute was incorporated within the streamlined Entity Transactions Law in 2015.

2. Similarly, in 2014 Arizona adopted a general corporate division statute as part of its Entity Restructuring Act.[3]

III. Overview of Current U.S. Transfer Laws and Division Laws

Although often mentioned in the same sentence, Transfer Laws and Division Laws are different. Transfer Laws allow an insurer to transfer legal liability of some or all business underwritten to another insurer. This restructuring can be within a group or to a third party. Division Laws, on the other hand, result in a corporate-level reorganization, similar to a merger.

A. <u>Mechanics</u>

1. Transfer Laws effect a transfer of policy liabilities from one company to another by regulator- or court-ordered novation. Transfer Laws were the first type of laws to be introduced in the U.S. that align with Part VII transfers in the

[2] 15 Pa.C.S. §§ 361 to 368.

[3] 29 A.R.S. §§ 2601 to 2608.

UK. The early U.S. adopters of Transfer Laws were attempting to attract insurance business to the insurers domiciled in their states.

a) Vermont: Legacy Insurance Management Act (2014).[4] The Vermont Transfer Law allows a Vermont-domiciled insurer to take over a closed block of commercial policies originally issued by a non-admitted insurer either directly or through surplus line brokers.

b) Rhode Island: Insurance Regulation 68 (2016).[5] The Rhode Island Transfer Law allows a Rhode Island-domiciled insurer to assume run-off blocks of property and casualty business from other insurers.

c) Oklahoma: Insurance Business Transfer Act (2018).[6] The Oklahoma Transfer Law expands from those of Vermont and Rhode Island to apply to any insurance blocks, in run-off or open for new business, and property and casualty or life and health policies.

2. Under a Division Law, an insurance company divides itself into two or more resulting companies through a plan of division that allocates assets and liabilities between the resulting companies and the division, like a merger, is effected by operation of law. The states with such Division Laws do not necessarily envision bringing business into these states immediately, rather those states see this law as providing a transformative means to facilitate efficient business transactions, improve competition and eventually attract insurance companies to the states. To be sure, the Division Law is not a new idea. As noted above, corporate divisions had a historical model in the Pennsylvania business corporations law. The detailed mechanics and regulatory considerations set forth in Connecticut's Division Law, however, were the first to specifically apply to insurance companies.

a) Connecticut: An Act Authorizing Domestic Insurers to Divide (2017).[7] A Connecticut plan of division must set forth certain elements prescribed by statute and be approved in accordance with the dividing insurer's organizational documents (which will be deemed to be the same requirements governing mergers if such organizational documents were adopted prior to effectiveness of the division statute). The plan will then need to be approved by the commissioner, after which the dividing insurer would file a certificate of division effecting the transaction.

[4] Chapter 147: Legacy Insurance Transfers (Vermont Insurance Code T. 8 § 7111 *et seq.*)

[5] R.I. Insurance Regulation R26-68-001.

[6] Okla. Stat. tit. 36 Art. 16C.

[7] Conn. Gen. Stat. §§ 38a-156r – 38a-156z.

b) Illinois: Domestic Stock Company Division Law (2018).[8] The mechanics of the Illinois statute generally mirror the Connecticut law.

c) Michigan: Domestic Stock Insurer Division (2018).[9] The Michigan statute is very similar to that of Illinois and Connecticut.

d) Iowa: An Act Relating to the Division of Domestic Stock Insurers (2019).[10] The Iowa statute is similar to the statutes passed in Connecticut, Illinois and Michigan.

e) Georgia: An Act to provide for division of a domestic insurer into two or more resulting domestic insurers (2019).[11] The Georgia statute is similar to the statutes passed in Illinois, Michigan and Iowa.

B. Scope

1. Transfer Laws

a) Oklahoma's Transfer Law evolves from its predecessors and allows any insurer to transfer and, by court order, novate a book of business to an Oklahoma-domiciled insurer (including a captive insurer). The Oklahoma law applies broadly to active and run-off books of business, and policyholders cannot opt out.

b) Under Vermont's Transfer Law, a non-admitted insurer from any jurisdiction may transfer closed blocks of commercial non-admitted insurance policies or reinsurance agreements to a Vermont-domiciled company established to acquire such closed blocks. All policy periods for the closed block must be fully expired for at least 60 months. The transfer, once approved by the Vermont regulator, has "the full force and effect of a statutory novation" although it allows policyholders or reinsurers to opt out.

c) Rhode Island's Regulation 68 allows any insurer to transfer run-off blocks of U.S. property casualty business to a Rhode Island-domiciled assuming company pursuant to a regulatory and judicial approval process, resulting in a novation of the business. Notice and hearing will be provided to policyholders but they cannot opt out.

2. Division Laws

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[8] 215 ILCS 5/35B-1 *et seq.*

[9] Mich. Comp. Laws § 500.5500 *et seq.*

[10] Iowa Code § 521I.1 *et seq.*

[11] Ga. Code Ann. § 33-14-120 *et seq.*

a) Unlike the Transfer Laws, which facilitate transfers of insurance business into insurers domiciled in states with such laws, the Connecticut, Illinois, Michigan, Iowa and Georgia Division Laws provide a means for an insurer domiciled in the state to divide into two or more domestic insurers.

b) The division, more like the reverse of a merger, applies to insurance companies on a corporate level and thus are not limited to classes of business or run-off blocks.

c) As discussed in some detail below, because a division creates new insurance companies, the new resulting companies' licenses, permits, and guaranty fund association will need to be reviewed in connection with a division and established as required by state laws.

IV. Considerations for Effectuating a Transfer Plan or a Division

Regulators will need to consider various factors in establishing review and approval guidelines. As noted, the NAIC is also developing a white paper with best practices.

A. Regulatory Considerations

1. Approval of Plan

a) A company seeking to effectuate a division or transfer must file a plan with the state insurance regulator (the "Plan"). The Division Laws and Transfer Laws set forth the requirements for the contents of the Plan, as well as the process for approval of the Plan.

b) Transfer Laws

(1) Contents of a Plan may include, for example, a description of the policies and reinsurance agreements to be transferred, financial information or opinions on the proposed Plan, and evidence that the Plan has been approved by the company's domiciliary regulator (in the case of a transfer from an out-of-state company to an in-state company, as is provided for in the Transfer Laws).

(2) Guidelines. The Transfer Laws prescribe detailed standards for the insurance regulator/court's approval of a Plan, which at a minimum requires a finding that the Plan will have no material adverse impact on policyholders (similar to the test for Part VII Transfers in the UK). Both Rhode Island and Oklahoma require approval or nonobjection from both the transferring and assuming company's domiciliary regulator.

(3) Independent Expert. In Rhode Island and Oklahoma the IBT plan must be supported by a report from an independent expert that must find no material adverse impact on all affected policyholders.

(4) Court Approval. In Rhode Island and Oklahoma, the Plan must be approved by a court after it has been approved by the state insurance regulator. Interested parties are provided an opportunity to be heard in connection with such court proceedings.

c) Division Laws

(1) In a division, the Plan will set out detailed allocation of assets and liabilities among the resulting insurers.

(2) Guidelines. Connecticut and Illinois allow, and Michigan, Iowa and Georgia require, the regulator to hold a public hearing on the Plan before issuing an approval. Regulators must be satisfied that interests of policyholders and other stakeholders are adequately protected under the division and the resulting companies have adequate assets to support its allocated liabilities.

2. Role of Policyholders and Reinsurance Counterparties

a) Transfer Laws

(1) Transfer Laws allow a company to transfer policy liabilities to a different company without consent of the policyholders. In Oklahoma and Rhode Island, a court implements the transfer; in Vermont the transfer is approved by the insurance commissioner. Transfers will include the attaching reinsurance.

(2) Under the current Transfer Laws, the policyholders and reinsurers will be provided notice of the transfer.

(3) In Vermont only, if a policyholder or reinsurance counterparty objects to the Plan, the assuming company must revise the Plan to exclude such policyholder or counterparty and the respective policy/contract from the Plan. Policyholders and reinsurance counterparties who fail to object are deemed to have accepted the plan.

(4) Under the Rhode Island and Oklahoma Transfer Laws, policyholders and reinsurers may comment on or object to the Plan, but do not have the right to opt out of or otherwise reject the transfer and novation. Under the Oklahoma Transfer Law, any party who considers himself or herself to be adversely affected

may present evidence or comments to the court at the approval hearing. However, such comment or evidence shall not confer standing on any person.

b) Division Laws

(1) The Division Laws of Connecticut, Illinois, Michigan, Iowa and Georgia permit a corporate-level transaction in which the policyholders and reinsurers do not actively participate, just like in a merger, spinoff or sale of an insurance company.

(2) In all current Division Laws, however, affected reinsurers will be provided reasonable notice of a plan of division.

(3) Generally, the insurance regulators of the dividing insurer's domiciliary state will be charged with ensuring that the interests of policyholders and other interest holders are adequately protected and that liabilities allocated by the division are adequately supported by assets of the resulting insurers.

3. State Licensing

a) Transfer Laws

(1) Transfer Laws focus on transferring insurance business to the entities domiciled in the state. Vermont's law has a very limited scope, and therefore the assuming insurer may only require a Vermont license to assume the closed block business.

(2) Under Rhode Island and Oklahoma's Transfer Laws, an entity licensed in a single state may not have the necessary authorizations to take over the transferred business. If the transferred business includes policies written in other states, the assuming entity will likely need to be licensed in such other states.

b) Division Laws

(1) One or more new companies will be formed pursuant to a Division Law. Because the state with the Division Law can only issue an insurance license of such state to a new entity, a licensing issue may arise if the business that it is allocated involves insurance policies issued in other states.

(2) Even if the resulting insurer is only allocated a run-off block, in most states, running off an insurance block means transacting insurance business, which requires insurance licenses

in the appropriate lines and in the states where the policies were issued.

(3) To address this issue, the Division Laws of the five current states also include an amendment to their existing merger statutes to provide for a simultaneous merger or consolidation of a licensed entity with the new resulting insurer. In the case of a division with a merger, the entity that is fully licensed to take on the business of the new resulting insurer would be the surviving entity.

B. Constitutional Considerations. Given the contrast between the Transfer Laws and the existing assumption reinsurance laws, and the perceived similarity of the end result of the Division Laws and the Transfer Laws, some have questioned the constitutionality of the new laws. Thus, in structuring a Plan, whether under a Transfer Law or a Division Law, it will be important to develop the Plan to withstand any potential challenges under the U.S constitution.

1. Due Process. The Transfer Laws essentially effectuate a novation of an insurance policy without the policyholder's consent. Consequently, there may be criticism that policyholders would be deprived of due process because they do not have the opportunity to affirmatively consent to the transfer of their policy to a new company. In response, the Plan should detail the specifics of the notice and opportunity to be heard to be afforded to affected policyholders during the process (*e.g.*, at a public hearing), as well as the process undertaken by the state insurance regulator and/or court to determine that a Plan would not adversely affect policyholders.

2. Contracts Clause. There may also be questions as to whether the Division Laws and Transfer Laws violate the Contracts Clause (which provides that a state may not pass laws impairing the obligations of contracts). As background, a state law does not violate the Contracts Clause unless its impairment of contractual rights is "substantial." With respect to the Transfer Laws and Division Laws, given that insurance business is subject to specific regulations, ensuring that there is a robust review process undertaken by the regulator to protect policyholders and counterparties would be a compelling counterargument that these parties' contractual bargain has been respected and preserved, and their rights are safeguarded. If the resulting insurers are adequately capitalized to meet their insurance obligations and have a better focus on certain lines of business, the law alone should not impair the contractual bargain. Additionally, it is common for insurance companies to engage in sales, mergers, or other corporate transactions to better align their business objectives and operate more efficiently and effectively. Those corporate level transactions, as with a division or transfer, do not involve any policyholder consent. Given the frequency of such transactions, it is not unreasonable to suggest that currently policyholders do not have an expectation that their policies will remain with the original writing company.

C. Guaranty Associations. In connection with Transfer and Division Laws, there have also been some questions regarding how a division will affect guaranty association coverage for policyholders. In practice, a division should not disrupt the current guaranty association coverage scheme because (i) immediately before the division, the insurer ought to have followed the necessary licensing requirements and be a member insurer in all relevant guaranty associations and have paid the relevant assessments, and/or (ii) following the division, due to the contemplated built-in merger or consolidation mechanism, the resulting new insurer could be merged into a properly licensed insurer.

Similarly, for transfers, if the transferred business includes policies written in other states, the assuming entity will likely need to be licensed in such other states so as not to disrupt existing guaranty association coverage.[12]

D. Reinsurance Arbitration Considerations

As of the date of this outline, we are not aware of any transactions that have been completed under the Division Laws or the Transfer Laws.[13] However, the insurance departments of several states have indicated that companies are in discussions with the departments with the goal of ultimately filing Plans. Since reinsurance agreements commonly include arbitration clauses, it is perhaps likely that a division or transfer of an insurance company's assets and liabilities will include reinsurance agreements that require the arbitration of disputes. Possible issues that might arise in an arbitration between a divided or transferred company and reinsurers would include issues seen in other reinsurance disputes involving successor entities.

A gateway issue may include a claim by the reinsurer that its agreement to arbitrate with the pre-divided or transferred company does not extend to the post divided company or transferred company. Such a claim might rely on the reinsurance agreements anti-assignment clause to associate the division or transfer with a prohibited assignment.

Whether a court or arbitrator reviews this issue, the review will likely include an examination of the scope of the division or transfer, the specific language of the arbitration clause and the requirements of applicable law.

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[12] However, for commercial P&C runoff blocks, a single licensed entity may be sufficient.

[13] As noted previously, in 1996 CIGNA effected a division of an insurance subsidiary to isolate asbestos liabilities in, although such division was pursuant to Pennsylvania's general business corporations division law. The Oklahoma Insurance Department has received two draft IBT Plans from prospective applicants and anticipates that the first IBT application will be approved by the Commissioner and the court process started by the end of 2019.

Attachments

1. Illinois Domestic Stock Company Division Law (215 ILCS 5/35B-1)
2. Oklahoma Insurance Business Transfer Act (36 O.S. § 1681)