CLIENT ALERT

Runoff Finality: Divide or Transfer?

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On January 1, 2019, Illinois' Domestic Stock Company Division Law[1][1] (the "Illinois Law") became effective. Similar to Michigan's Domestic Stock Insurer Division Law[2][2] (the "Michigan Law") (which took effect on December 20, 2018), Connecticut's Act Authorizing Domestic Insurance Companies to Divide[3][3] (the "Connecticut Law") (which took effect on October 1, 2017), Georgia's Domestic Insurer Division Act (the "Georgia Act")[4][4] (which will take effect on July 1, 2019) and Iowa's Act Relating to the Division of Domestic Stock Insurers[5][5] (the "Iowa Act") (which will take effect on July 1, 2019), the Illinois Act permits Illinois-domiciled stock insurance companies to divide into two or more stock insurance companies, and to allocate specified liabilities (including insurance policy liabilities) and assets between and among the resulting entities. The Illinois Law joins, not only the aforementioned insurance company division laws of Connecticut, Georgia , Iowa and Michigan, but the similarly inspired insurance business transfer laws and/or regulations of Oklahoma,[6][6] Rhode Island,[7][7] and Vermont,[8][8] all of which are designed to separate proscribed books of discontinued insurance or reinsurance business from the original insurer/reinsurer and thus to afford some measure of finality to the runoff of those books.

In an article published late last year[9][9], we reviewed the principal operative provisions of the insurance business transfer structure as exemplified by Oklahoma's business transfer act and Rhode Island's Regulation 68, and discussed some of the potential legal vulnerabilities of the business transfer mechanism. In this article we review the principal operative provisions of the business division structure as exemplified by the Illinois Law and discuss the relative merits of the business transfer vs. the business division approach to runoff finality, from the perspective of an insurer or reinsurer evaluating the optimal disposition of a portfolio of legacy liabilities.

The Illinois Law permits any Illinois-domiciled stock insurance company (the "Dividing Company") to divide into two or more Illinois-domiciled stock insurance companies (the "Resulting Companies"), in the process allocating selected assets and liabilities of the Dividing Company to the Resulting Companies. The asset-liability allocation is effected pursuant to a plan of division filed by the Dividing Company with the Illinois Director of Insurance (the "Director"), specifying, *inter alia*, the liabilities (including direct insurance and /or reinsurance liabilities) intended to be transferred and the assets and reserves that are proposed to support the transferred liabilities. Provided that the plan of division contains all of the information specified in section 35B-15 of the Illinois Law,

> [t]he Director *shall approve* a plan of division *unless* the Director finds that: (1) the interest of any class of policyholder or shareholder of the dividing company will not be properly protected; . . . (3) the proposed division . . . violates . . . the Uniform Fraudulent Transfer Act; (4) the division is being made for purposes of hindering, delaying, or defrauding any policyholders or other creditors of the dividing company; (5) one or more resulting companies will not be solvent upon the consummation of the division, or (6) the remaining assets of one or more resulting companies will be . . . unreasonably small in relation to the business and transactions in which the resulting company . . . is about to engage (emphasis added)[10][10].

Following the Director's approval of a plan of division, a Resulting Company is individually responsible, by operation of law (not on the basis of a transfer or assumption), only for the liabilities of the Dividing Company that are allocated to the Resulting Company pursuant to the plan of division, as well as for any going-forward liabilities incurred by the Resulting Company in its individual capacity subsequent to the division[11][11]. The Illinois Law allows - - but does not require - - the Director to hold a public hearing on a plan of division, in contrast to Oklahoma's and Rhode Island's business transfer regimes; unlike the business transfer approach, the Illinois Law does not require judicial confirmation in order for the Director's administrative approval to take effect.

The foregoing bases on which the Director may disapprove a plan of division encompass most of the potential legal grounds on which a shareholder, policyholder or creditor of a Dividing Company could challenge the finality of an approved division; by extension, the Director's approval of a plan of division would constitute *prima facie* evidence that the plan of division is fair to shareholders, policyholders and creditors and likely would survive challenge on those grounds, at least in an Illinois state court.

Although the Director's approval of a plan of division of an Illinois Dividing Company might provide legal insulation for the Dividing Company and the Resulting Compan(y)(ies) in Illinois, it should not be assumed that an Illinois Dividing Company that derives a substantial portion of its business from other states would enjoy automatic deference on the part of ancillary state regulators to the rulings of the Illinois Director. In particular, state insurance regulators in California, New York and Texas might invoke their own laws to challenge the validity of a transfer of policy liabilities from Dividing Insurer to Resulting Insurer that implicates insureds or exposures located in their jurisdictions. For example, California's law[12][12] prohibiting substantial transfers of business by a licensed insurer - - whether or not domiciled in California - - without prior approval of the California Insurance Commissioner, or New York's regulation requiring prior approval of a licensed insurer's withdrawal of business lines from the New York market, could be invoked to disallow an Illinois domestic's approved plan of division insofar as it impacts policyholders or exposures in those states. Even smaller states whose assumption reinsurance laws require prior approval of licensed insurers' business transfers[13][13] could aggressively invoke their laws to protect policyholders and claimants in their states from an Illinois Dividing Company's perceived attempt to place their constituents in a weaker financial position.

Similarly, a newly divided Resulting Company is not likely to be licensed in any ancillary jurisdictions at the time of the Director's approval of the plan of division in Illinois, and therefore will not be a member of any ancillary states' guaranty funds. If the Resulting Company were to become insolvent, ancillary state policyholders and claimants could find themselves bereft of guaranty fund protection. Comity considerations are not likely to preclude an ancillary state insurance commissioner from challenging an Illinois-approved plan of division if she views a Resulting Company to constitute a “bad bank” that affords weaker financial security to local policyholders and claimants.

Further, although the Illinois Law properly conditions the Director’s approval of a plan of division upon a finding that the proposed division does not entail a fraudulent transfer, that determination almost certainly will not bind an ancillary state insurance regulator, let alone an ancillary state court before whom a policyholder or claimant alleges fraud. While the U.S. Constitution mandates that states accord full faith and credit to final judgments of other states’ courts,[14][14] it is not clear that an ancillary state policyholder would be precluded from maintaining a fraud-based action by the Director’s purely administrative decision incorporating a no-fraud finding, particularly if that policyholder was not afforded an opportunity to object to the plan of division (because, for example, the Director did not hold a public hearing on the plan) or if that ancillary state policyholder simply was not aware that her insurer had transferred her policy to another entity. Even if an Illinois policyholder or claimant unsuccessfully challenged a plan of division in Illinois state court on fraudulent transfer grounds, collateral estoppel principles would preclude that judgment from binding an unaffiliated policyholder or claimant who was not a party to that litigation and had not been afforded a full and fair opportunity to litigate the fraudulent transfer issue. Illinois courts have repeatedly so held,[15][15] as have courts in many other states.

More central to any finality analysis, however, is the potential application and interpretation of section 35B-40(d) of the Illinois Law[16][16] - - and its analogues contained in each of the insurance company division statutes that, as of this writing, have been enacted in other states[17][17] - - which provides that “[i]f a division breaches a contractual obligation of the dividing company at the time the division becomes effective, all of the resulting companies are liable, jointly and severally, for the contractual breach . . ..” Although as-yet untested, this provision could potentially be invoked by aggrieved policyholders, cedents and other claimants to challenge any post-division diminution in their *prima facie* claim values by attributing any putative shortfall to the division, thus rendering the Dividing and Resulting Companies jointly and severally liable for the full balance of the obligation. For a Dividing Company seeking finality in respect of a portfolio of discontinued business, the uncertainty flowing from the potential application and interpretation of this statutory provision could complicate actuarial valuation of reserves earmarked for transfer to the Resulting Company and preclude issuance of clean accounting and legal opinions required to consummate the division transaction.

As of this writing there have been no insurance company division transactions consummated under any of the various insurer division statutes currently in force, nor have any insurance business transfer transactions been completed pursuant to the business transfer laws of Oklahoma or Vermont, or Rhode Island’s Regulation 68; accordingly, many of the potential weaknesses inherent in both the business transfer and insurer division approaches to achieving runoff finality have yet to be tested in the context of actual transactions and subsequent regulatory or court challenges. In response to the prevailing high level of insurance industry interest in this area, however, the National Association of Insurance Commissioners recently created a Working Group on Restructuring Mechanisms tasked with reviewing and analyzing all of the laws and regulations that have been enacted or promulgated to address the manifest industry demand for finality in insurance business transfers, with a view to issuing a white paper discussing the issues presented and proposed regulatory proscriptions for addressing them. Until that time, the insurance industry will continue to evaluate each new statutory option for shedding or containing runoff liabilities, hoping that one of them will provide a roadmap to achieving the elusive goal of finality.

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[1] Ill. Rev Stat. ch. 215, § 5/35B-1 et seq.

[2] Mich. Comp. Laws ch. 500, § 5500 et seq.

[3] Conn. Gen Stat. ch. 698, § 38a-156r et seq.

[4] Act 147, 2019 Ga. Laws 19 (May 2, 2019)

[5] 2019 Iowa Acts, House File 264 (April 9, 2019)

[6] 2018 Okla. Stat. ch. 36, § 1681 et seq.

[7] Rhode Island Insurance Regulation 68, Reg. R27-68-001 (issued Sept. 5, 2004; amended Aug. 18, 2015)

[8] Vt. Stat. Ann. tit. 8, § 7111 et seq.

[9] "Oklahoma's Insurance Business Transfer Act: Objections Overruled," *Law 360* (October 19, 2018)

[10] Ill. Rev. Stat. ch. 215 § 5/35B-25(b)

[11] Ill Rev. Stat. ch. 215 § 5/35B-35(a)(6)

[12] Cal. Ins. Code § 1011

[13] *See, e.g.*, Ga. Code Ann. § 33-52-6

[14] U.S. Const. art. IV, § 1

[15] *See, e.g.*, Talarico v. Dunlap, 177 Ill. 2d 185, 191 (1997)

[16] Ill. Rev. Stat. ch. 215 § 5/35B-40(d)

[17] *See* Connecticut Law *supra*, § 38a-156x(b); Georgia Act *supra*, § 33-14-126(b); Iowa Act *supra*, § 521I.12(4); Michigan Law *supra*, § 500.5513(4).

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