Legacy lab

Sean Thomas Keely considers the options for run-off in the US and asks whether states have yet to prove themselves productive laboratories for legacy solutions

Justice Louis Brandeis famously wrote in a US Supreme Court opinion in 1932: "It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country."

His turn of phrase has since been picked up to describe the states metaphorically as "laboratories of democracy".

In the dual sovereignty system in America, some things are within the purview of the federal government to arrange on a national level while others are left to the states where local legislators can be more responsive to local concerns and opportunities. In theory, this can lead to healthy competition among states for residents, businesses and capital.

State laboratory

One can question, however, whether states have yet been a productive laboratory for legacy (re)insurance solutions.

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states. There is coordination among the states, primarily through the National Association of Insurance Commissioners (NAIC), which allows state insurance regulators to work together in setting standards and coordinating oversight. But ultimately the environment for (re)insurers – including the availability of legacy solutions – is determined by the legislation and regulation in the particular state.

The US can thus seem generations behind in this area, particularly when one considers that Part VII has been on the books in the UK for nearly two decades, with over 250 transfers sanctioned in that time.

Nevertheless, there continues to be momentum in the US – some might legitimately call it slouching momentum – toward legislative and regulatory solutions for legacy business.

There should certainly be market appetite for those solutions given the size of the US non-life run-off market nearly equals that in the rest of the world combined. Where are there recent signs of hope for progress?

Division statutes

In the past several months, Iowa and Georgia have each enacted insurance division statutes, with both taking effect on 1 July 2019. This brings the number of states with division statutes to over half a dozen. These laws provide a mechanism for an insurer to restructure legacy business into a separate insurer, often with the idea that the business can be operated more efficiently in the stand-alone entity or sold on. While the mechanism offers advantages, it probably does not offer finality.

The laws generally provide that a plan of division must be approved by the regulator and that the liabilities allocated in the plan to the resulting insurer after the division remain with that resulting insurer.

But the Georgia law contains a provision that "[i]f a division breaches an obligation of the dividing insurer, all of the resulting insurers shall be liable, jointly and severally, for the breach, but the validity and effectiveness of the division shall not be affected by the breach". The other division statutes contain similar provisions.

This, of course, leaves open the possibility that a liability intended to be housed separately forever comes back to haunt. Nevertheless, as noted, such division statutes continue to gain traction in the US. And where they have been adopted they have largely been at the prompting of insurance companies advocating for them as useful solutions.

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Insurance business transfers

More aspirational in the US are insurance business transfers (IBTs), akin to transfers under Part VII where legal finality can be achieved by a novation and transfer of liabilities sanctioned by court order.

The Insurance Business Transfer Act in Oklahoma became effective on 1 November 2018. It is the most direct cognate in the US to Part VII, applying to P&C, life and health, as well as any other line of business the regulator thinks suitable for IBT.

Its forerunner, Regulation 68 in Rhode Island, provides procedures for IBTs of P&C commercial run-off business and has been in effect since 2016. But no IBT has yet been undertaken in either state. Why not?

Certainly, there is the execution risk to consider, particularly as a first mover testing the procedures. What will the regulators require in approving a plan and how will courts address them (and how long will it take)?

More substantively, there are still underlying constitutional questions that may need to be sorted out. The US Constitution contains a Contracts Clause that prohibits any state from passing a law "impairing the obligation of contracts". Some have questioned whether an IBT law might run afoul of that prohibition.

The Constitution also contains a provision requiring states to give "Full Faith and Credit" to judicial proceedings of every other state. States must honour judgments validly entered in other states.

But that may leave open questions of the jurisdiction of the court in the IBT state over certain policyholders in other states or whether the procedures in the IBT pass muster for full faith and credit.

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But while there are questions to be answered, there is hope for progress. Market members continue to have exploratory discussions with regulators regarding potential IBT transactions.

Earlier this year the NAIC formed a Restructuring Mechanisms Working Group to consider, among other things, issues relating to the various mechanisms that have been enacted or proposed as well as some of the legal issues presented. This reflects the real interest of the regulatory as well as the business community in finding effective solutions.

In the meantime, the laboratories await that first visionary market member to attempt the alchemy of a US IBT.

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