BUSINESS INSURANCE

Runoff business faces myriad complications

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Despite a large amount of reserves in discontinued insurance lines and ample specialists at the ready to assume them, the runoff business is mired in cumbersome processes and arcane regulation. Sean Keyvan, a partner with Sidley Austin L.L.P. in Chicago, discusses the need for effective state laws to facilitate the transfer process while protecting policyholders' rights.

There are hundreds of billions of dollars worth of insurance reserves in discontinued books of business throughout the United States — and a growing number of runoff specialists that stand willing to acquire them. Amid the burgeoning market for runoff blocks, insurers are increasingly seeking strategies to transfer them to third parties who may be better equipped to administer legacy business.

Though the decision to discontinue a line of business may be a sound long-term strategy for many insurers, managing runoff blocks can present substantial challenges. Runoff blocks can drain the resources of an insurer, divert time and capital from profitable products and quickly become a distraction, especially given insurers' increasingly stringent capital requirements. Further, it becomes more difficult to retain qualified staff as policies mature and the block shrinks over time. For these reasons, insurers can be expected to continue their pursuit of exit mechanisms from claims exposure associated with legacy business.

Runoff specialists have not hesitated to capitalize on these realities, and in many ways, the transfer of closed blocks can create economic efficiencies for the insurance industry. Legacy business may take on a very different character when held by runoff acquirers who have expertise in certain long-tail risks and will likely manage runoff blocks more actively than carriers that relegate them to a lower priority.

Despite the benefits that the transfer of closed blocks may provide, insurers' efforts in this area have been somewhat stymied by limited legal avenues available to pursue such transactions. In general, insurers in the United States have traditionally shed their legacy blocks through the sale of insurance companies, the use of indemnity reinsurance and the transfer of individual policies through assumption reinsurance. However, none of these mechanisms provides a comprehensive solution to many runoff transfer issues, and therefore cannot meet the demands of the growing runoff market.

Though the sale of an insurance company may provide the cleanest break from a discontinued business, it is not always practical. The runoff block may not be isolated in a single legal entity with no other active business, and buyers may be reluctant to take on liabilities other than those relating to the target business.

Indemnity reinsurance does not allow for clean transfers either, as ceding insurers remain primarily liable to policyholders, so they must bear the credit risk of a reinsurer's default. Also, the cedent must continue to administer the runoff business or allow the reinsurer to administer without contractual or regulatory responsibility for it.

Assumption reinsurance, on the other hand, may provide finality because it releases the insurer from liability. But the assumption process is cumbersome, lengthy and costly, and there is no guarantee that all policies will be transferred even if an insurer meets statutory requirements. Complicating matters is a disparate patchwork of state laws that governs assumption reinsurance in the United States. Moreover, many states do not provide explicit authority or guidance with respect to assumption reinsurance.

Regulators in some U.S. jurisdictions have begun to recognize the need for reform in this space and have fashioned statutory mechanisms for certain runoff structures.

Under a 2002 law, Rhode Island, for example, allows for the voluntary restructuring of the runoff commercial business of a solvent insurer (workers' compensation, life and health policies and personal lines are expressly excluded). This past August, Rhode Island amended its regulations to allow any commercial insurer (domiciled in Rhode Island or not) to transfer runoff business to Rhode Island-domiciled insurers through a court-ordered process. Policyholders are protected by broad notice and threshold consent requirements that must be met before a transfer can occur, and the cedent must demonstrate that the reinsurer can satisfy obligations to policyholders.

Similarly, a Vermont statute allows for the transfer of legacy business, albeit through a regulatory approval process. .

Similar procedures for the transfer of legacy business have been available for some time in the United Kingdom in the form of Part VII Transfers and solvent schemes of arrangement. But the advent of uniform, nationwide regulation with respect to the transfer of closed blocks in the U.K. highlights the obvious hurdles in establishing similar mechanisms in the U.S., where insurance is primarily regulated at the state level.

Notwithstanding the efforts in Rhode Island and Vermont, the utility of these statutes with respect to the larger runoff market remains to be seen. As a threshold matter, such transfers are available only in Vermont and Rhode Island, where relatively few insurance companies are domiciled. In addition, the application of the Rhode Island and Vermont statutes to non-domestic insurers and nonresident policyholders is questionable. So it remains unclear whether such transfers are enforceable across state lines — they may be challenged on jurisdictional and due process grounds (can the laws of one state alter the rights of nonresident policyholders?) as well as conflicts of law principles (can the laws of one state affect contracts governed by the laws of another state?). For insurers with policyholders in multiple states, this lack of clarity may limit the practical utility of these statutes.

Moreover, any statutory transfer scheme may trigger constitutional concerns (including impairment of contract and due process considerations) even with robust notice requirements. Although at least one court has ruled that a restructuring under the Rhode Island statute did not "substantially impair" the rights of policyholders so as to violate the Contracts Clause of the U.S. Constitution, other courts may disagree. Policyholders' rights under the U.S. Constitution and state law equivalents add to the complexity of the situation.

A comprehensive, coordinated and uniform mechanism for the transfer of legacy blocks is therefore necessary. Such a holistic approach would benefit the insurance industry generally, and policyholders (who have an interest in ensuring that their rights are protected), in particular. Because regulatory uniformity among the states is essential to the success of any system allowing for the transfer of legacy business, the National Association of Insurance Commissioners is perhaps most qualified to lead the effort. Absent uniform treatment of legacy transfers among the states, effective exits for primary insurers will be difficult to attain.

Of paramount importance to any successful runoff transfer mechanism, is, of course, the protection of policyholders. This can be achieved by ensuring that assuming insurers honor the contractual obligations to each insured. As such, runoff transfer mechanics must be established with an eye toward policyholder protection (as demonstrated by Rhode Island and Vermont), and any such approach must safeguard against the material impairment of the rights of policyholder under the transferred policies.

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