GOING THEIR SEPARATE WAYS

The Pennsylvania Entity Transactions Law leaves the door open for further separation and restructuring opportunities for Pennsylvania domiciled insurers with legacy or run off liabilities

By Andrew Rothseid[1]

Owners of insurers and reinsurers with legacy liabilities within active underwriting entities struggle to find statutory 'tools' that allow them to: (1) honor their contractual obligations; and (2) protect their shareholders, prospective policyholders and active underwriting entities from the potential adverse development, expense, and management distraction associated with the legacy business.

Few states provide insurers with such tools. Among the rare examples is Rhode Island's 'Voluntary Restructuring of Solvent Insurers'[2]. The Rhode Island Statute allows a Rhode Island domiciled insurer, with only eligible commercial liabilities, to crystallize the insurer's exposure to its policyholders as at a certain date and, upon regulatory, policyholder, and court approval of a "commutation plan", accelerate the closure of the insurer paying the policyholders 100% of the net present value for their agreed claims.

The Rhode Island Statute also allows an active underwriting insurer or reinsurer, domiciled within or outside Rhode Island, to form or reactivate an entity and then place liabilities that are eligible for closure under the Rhode Island Statute in the new or reactivated

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[2] Chapter 27-14.5 (the 'Rhode Island Statute')

insurer.[3] In 2015, amendments to the Rhode Island Statute's Regulation 68 were approved to provide the process for the separation or transfer of eligible business.

The Pennsylvania Entity Transactions Act[4] (the 'New Act') offers additional options for Pennsylvania domiciled insurers. It streamlines the process by which corporations domiciled in the state can enter into various transactions. Chapter 3 of the New Act, based upon the Model Entity Transactions Act, provides greater clarity to proposed mergers, interest exchanges, conversions, domestications and, as most relevant here, divisions of Pennsylvania domiciled insurers. Prior to the New Act, Pennsylvania domiciled insurers could – and did – separate their legacy or 'run off' exposures from active business.

This note provides an overview of the application of the previous statutory regime to legacy liabilities and outlines the updated process that has come into force under the New Act.

Opening the way for separation

Pennsylvania's Business Corporations Law[5] has provided Pennsylvania corporations with a process and procedure by which they can divide their business into separate entities. This process has been used, successfully, by a Pennsylvania insurer that wanted to separate its legacy/run off liabilities from its active underwriting balance sheet.

On February 7, 1996, the Pennsylvania Insurance Department, and other regulators, approved a Plan of Restructure that placed all of ACE USA's Domestic Property and Casualty Insurance's Group's run off business within Century Indemnity Insurance Company, a subsidiary of Brandywine Holdings. The Plan of Restructure was based upon

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[3] Closure of a solvent insurer in run off under the Rhode Island Statute has been upheld as constitutional. See In Re GTE REinsurance Company, C.A. No. PB 10-3777 (April 25, 2011). See also http://runoffresolve.com/first-us-solvent-scheme-of-arrangement/

[4] House Bill 2234, passed October 22, 2014, effective July 1, 2015

[5] 15 Pa C.S. § 1951 et seq. (the "Act")

the provisions of the then Pennsylvania Business Corporations Law to separate inactive elements of the property and casualty (P&C) portfolio from active business.

The move followed the downgrading of the credit rating (A- to B++) of CIGNA's[6] P&C business in the wake of poor underwriting returns and significant exposure to asbestos and environmental (A&E) liabilities. Inter-company reinsurance arrangements enabled CIGNA to temporarily bolster its rating. But it was looking for a longer term solution. Separation of the inactive A&E portfolios enabled the active business to increase its rating and focus resources on new business development.

As with all such divisions, the CIGNA restructuring required board and shareholder approval and was subject to fairness and solvency opinions.[7] There were also actuarial reviews of various financial and accounting measures. Policyholders were consulted, but the process did not require their approval. In the case of CIGNA, the process also required court and regulatory approval for re-domiciliation in Pennsylvania from states in which the company had affiliates, such as California.

A legal challenge in 1999 claimed that the process should be subject to adversarial hearings prior to approval of the restructuring and division of an insurance company in line with the Administrative Agency Law. But the case was soundly rejected[8], keeping the door open to this pragmatic, but fair and well scrutinized process.

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[6] CIGNA, the result of an earlier transaction between Connecticut General Insurance Company and the Insurance Company of North America ("INA"), was the ultimate parent of ACE USA and, after the restructuring, of Brandywine Holdings and Century Indemnity.

[7] On July 2, 1999 CIGNA sold INA Corporation and its subsidiaries, including Brandywine and Century, to ACE INA Holdings, Inc.

[8] LaFarge Corp. v. Commonwealth of Pennsylvania Insurance Department, 557 Pa. 544, 735 A.2d 74 (1999).

Brandywine Holdings, and its subsidiary Century Indemnity, have operated in solvent run off since the division was upheld.

Fundamentals remain, but some changes

The 2014 legislation that created the New Act upholds the fundamentals of the separation process. In particular, the new Section 321 maintains the previous rules and regulations requiring board and shareholder approval (unless a merger or reorganization can be accomplished without such approvals pursuant to another section of the statute) and the presentation of merger documents or summaries thereof.

The most significant changes are in Chapter 4 relating to the direct conversion of a business organization from a foreign to a domestic entity (or vice versa), which was previously only allowed by merger or some similar action.

The substantive new provisions include:

- Names (new Chapter 2)
- Fundamental or entity transactions (mergers, interest exchanges, conversions, divisions and domestications) (new Chapter 3)
- Registration of foreign entities (new Chapter 4). The New Act contains many new definitions and requires practitioners to learn a new vocabulary. Act 172 modernizes the law on corporations and unincorporated associations by creating a comprehensive statutory framework for a business entity to use when engaging in a transaction with another form of entity. The New Act governs five fundamental kinds of transactions which may take place regardless of the form of the business entities involved:

  1/ Merger of one entity with or into another;

2/ Conversion of one type of entity to another type of entity (e.g. business corporation to limited liability company);

3/ Interest exchange between two entities so that one of them is controlled by the other without actually merging the entities;

4/ Division of one existing entity into two or more resulting types of associations; and

5/ Domestication into Pennsylvania of an entity originally organized in another state.[9]

New types of forms need to be filed for mergers, divisions and domestication of foreign entities, among other activities, and several forms relating to foreign entities have been amended.

Any company contemplating a transaction under Section 321 should review these provisions in the process of identifying necessary filings, which would be related to the particular structure of the transaction.

Separation still on the table

So what does this mean for separation? Nothing in Section 321 should prevent an insurance company from performing a separation along the lines of the 1996 transaction through which Brandywine Holdings and Century Indemnity were created, though certain forms and filing requirements have been updated, as outlined earlier.

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[9] (Source: Pennsylvania Department of State Website at http://www.dos.pa.gov/BusinessCharities/Business/Documents/Coming%20soon%20META.pdf).

Therefore, while the CIGNA separation appears to be the only such restructuring undertaken through the Act, other companies would still be able to follow suit – and separate their legacy/run off liabilities from their active balance sheets – as long as they meet the review and approval criteria of the New Act.

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