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Dodd-Frank to simplify multi-state reinsurance regulation, depriving non-domiciliary states of much of their ability to regulate reinsurance, including in transactional contexts.

As the insurance community is well aware, last year's Dodd-Frank Wall Street Reform and Consumer Protection Act¹ goes beyond regulation of banks, derivatives and "too big to fail." In provisions that received much less fanfare,² Dodd-Frank tackles some of the extraterritoriality of state insurance laws, i.e., situations where an insurer must comply not only with the law of its domiciliary state but also with that of other states where it does business, creating duplication at best and confusion and inefficiency at worst. One such area concerns the regulation of reinsurance and reinsurers. In making meaningful reforms in this space (some of which are described below), the Act strikes a blow for harmonization of state laws. However, the statute may have other consequences that are worth considering, particularly as insurance M&A heats up again.

The principal reinsurance issue that Dodd-Frank confronts is so-called credit for reinsurance, or the ability of an insurer to record an asset on its balance sheet (or to debit a liability) where risks are ceded to a reinsurer. Under Section 531(a) of the Act, the domiciliary state regulator is the *only* regulator with discretion over a ceding company's ability to take such financial statement credit. Other states where the ceding company is licensed must defer to the determination of the domiciliary state. When this provision becomes effective on July 21, 2011, it will eradicate an oddity of reinsurance law that has bedeviled ceding and assuming companies for decades – the need to qualify for reinsurance credit in multiple states.

However, Section 531 does not stop there. It preempts all laws and "actions" of a non-domiciliary state to the extent that they (1) restrict the right to arbitrate disputes under a reinsurance contract, (2) require that that state's law must govern the reinsurance contract, (3) attempt to enforce a reinsurance contract on terms different from those set forth in the contract, or (4) "otherwise apply the laws of the state to reinsurance agreements of ceding insurers not domiciled in that state."

Bulk reinsurance requirements imposed by conservatorship statutes. The scope of item (4) in particular has possible effects beyond merely harmonizing discrepant state laws. Consider conservatorship provisions such as Section 1011(c) of California Insurance Law. This statute permits the California insurance commissioner to seek conservatorship in the event that an insurer (even one not domiciled in California) enters into "any transaction the effect of which is to merge, consolidate, or reinsure substantially its entire property or business in or with the property or business of any other

¹ Public Law 111-203.

² Specifically, Title V, Subtitle B of the Act, known as the Nonadmitted and Reinsurance Reform Act of 2010 ("NRRRA"). Prior to Dodd-Frank, versions of NRRRA had been adopted by the U.S. House of Representatives in successive Congresses, but not adopted by the Senate.

person" without the commissioner's prior consent. (Regulations issued by the California Department of Insurance clarify that reinsurance of at least 75% of one's business is enough to trigger the statute but specify that the threshold percentage could be lower in the Department's discretion in any given case.³)

Section 1011(c) sets out grounds for conservatorship and does not, strictly speaking, impose any affirmative obligation relating to a reinsurance contract. The role of state insurance departments in financial oversight of insurers is, of course, one of the hallmarks of the state regulatory system, and it is widely accepted that states can commence conservatorship or even rehabilitation or liquidation proceedings against an insurer doing business, but not domiciled, in the state.

By the same token, practitioners commonly interpret Section 1011(c) as imposing a requirement on insurers licensed in California to seek the commissioner's approval before effectuating certain "bulk reinsurance" arrangements; the statute has been the bane of many change-of-control transactions involving national carriers not domiciled in California. If the statute (like its equivalent in numerous other states) expressly imposed such a requirement, there can be little doubt that Section 531 would preempt it in the case of a non-California domestic ceding insurer. It seems reasonable to conclude that Section 1011(c)'s *implicit* requirement should also be deemed invalidated. If such is the case, M&A deals in deals in which California is not the domicile of any party could be facilitated by obviating the potentially major hurdle of having to obtain California insurance regulatory approval.

Possible effect on assumption reinsurance, or novation, transactions. Another context in which Section 531's impact is unclear concerns assumption reinsurance. Unlike normal "indemnity" reinsurance, in which the ceding company remains legally obligated on the risk and is merely entitled to indemnity from the reinsurer, assumption reinsurance involves the substitution by the reinsurer for the ceding company on the primary risk itself. Generally, the primary insured's consent is required for this substitution insofar as the contract between it and the ceding company is being replaced with a new contract between the insured and the reinsurer. Hence assumption reinsurance is often referred to by the more precise term "assumption and novation."

A number of state statutes impose requirements on assumption reinsurance even where the ceding company is not domiciled in the state.⁴ In other states, bulk reinsurance statutes are on the books that purport to cover non-domiciliary ceding companies, but regulators have historically taken the position that these requirements apply only in the case of assumption reinsurance. The policy underlying these statutes and interpretations is that an insurance regulator is entitled to oversight authority where a carrier doing business in his state seeks to substitute a different carrier for itself on policies issued to residents of his state. However, it may fairly be asked whether Section 531 requires that such transactions be subject to the oversight of the domiciliary state only. After all, a policyholder always has the ability to surrender or non-renew a policy if the policyholder does not approve of the new carrier, and it can be argued that this remedy is an adequate substitute for the oversight of a non-domestic regulator — the customer can simply terminate the relationship. If Section 531 is enforced in this manner, vastly simplifying the regulatory process associated with novation transactions, assumptions of blocks of policies could be facilitated considerably.

³ 10 Calif. Code of Regs. §2303.15.

⁴ See, e.g., Kansas Ann. Stat. §40-5201 *et seq.*; Oregon Rev. Stat. §742.150 *et seq.*; Official Code of Georgia Ann. §33-52-1 *et seq.*

Regulation of "reinsurers." Dodd-Frank's provisions on reinsurers are also noteworthy. For the most part, state insurance codes do not distinguish between primary insurers and reinsurers.⁵ In other words, reinsurers domiciled and licensed in NAIC jurisdictions are subject to the same requirements as direct carriers. Dodd-Frank represents the first significant attempt in U.S. financial regulation to recognize a specific class of insurance companies as "reinsurers" and to create certain distinct rules for them. Section 533(5) defines reinsurer as an insurer "to the extent that the insurer . . . (i) is principally engaged in the business of reinsurance; (ii) does not conduct significant amounts of direct insurance as a percentage of its net premiums; and (iii) is not engaged in an ongoing basis in the business of soliciting direct insurance. . . . A determination of whether an insurer is a reinsurer shall be made under the laws of the state of domicile . . ."

This definition seems likely to produce classification disputes. Intending to isolate a class of insurers for special treatment as "reinsurers," the drafters punted on delineating exactly whom the class should consist of. Phrases such as "principally engaged" and "significant amounts" are destined for regulatory or even judicial refinement. Until such refinement, some measure of confusion can reasonably be anticipated.

Once a "reinsurer" is identified, Section 532 states that if its "[s]tate of domicile . . . is an NAIC-accredited [s]tate or has financial solvency requirements substantially similar to the requirements necessary for NAIC accreditation, such [s]tate shall be solely responsible for regulating" the reinsurer's solvency. This raises the intriguing prospect of an insurer (*i.e.*, one classified as a "reinsurer") no longer having to face the risk of ancillary receivership proceedings. Consider a New York domiciled insurance company with a license in Pennsylvania. The company has policyholders resident in Pennsylvania and maintains significant assets there. In the event of distress, Pennsylvania could assert the right to conduct ancillary proceedings.⁶ However, if the insurer conducts enough reinsurance so as to fall in Dodd-Frank's definition of "reinsurer," the Pennsylvania regulator may be barred from conducting receivership proceedings regardless of the quality of New York's process. Pennsylvania, after all, would in this instance be a non-domiciliary state and therefore incapable of regulating solvency under Section 532. In other words, did the framers of Dodd-Frank, in classifying an entity as an insurer or reinsurer, intend to vitiate a non-domicile's ability to conduct ancillary receivership proceedings over a reinsurer?

Long after the cheering has died down for Dodd-Frank's significant strides in harmonizing state insurance laws, carriers, regulators and even courts will likely be facing these and related issues in reinsurance regulation. Indeed, the first wave of insurance M&A transactions following this summer's effective date will have to confront these in more or less a vacuum. Which way these questions come out could signal the next steps in the trajectory of insurance regulation in this area.

⁵ By contrast, Solvency II, Europe's nascent insurance regulatory regime, distinguishes between these, regulating insurers and reinsurers somewhat differently. See Directive 2009/138/EC of the European Parliament and of the Council of 25 Nov. 2009 at Art. 13.

⁶ 40 P.S. Section 221.56, modeled on the old Uniform Insurers Liquidation Act ("UILA"), permits such ancillary proceedings if the Pennsylvania regulator finds there are sufficient assets of the insurer located in Pennsylvania to justify such proceedings or "if the protection of creditors or policyholders in [Pennsylvania] so requires." For additional examples of such grants of authority under the UILA, see Rev. Code of Wash. 48.99.030; Del. Insurance Law §5914; and New York Insurance Law §7406. See also NAIC Insurer Receivership Model Act §1001(A).

For More Information

Our client alerts are for general informational purposes and should not be regarded as legal advice. If you would like additional information or have any questions, please contact:

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