The Low Down on LIMA

The Legacy Insurance Management Act

Effective February 19, 2014, Vermont enacted legislation, the Legacy Insurance Management Act ("LIMA"), to facilitate what some had hoped would become a US version of Part VII of the UK Financial Services and Markets Act 2000 ("UK Part VII") which has become a well-known vehicle to transfer books of assets and liabilities between insurers in the UK and elsewhere ("Part VII Transfers").

Following the success of Part VII Transfers, operators of run-off insurers in the US and abroad have been searching for ways to transfer similar blocks of US insurance (and reinsurance) business to insurers in the US.

A previous legislative enactment in Rhode Island effective in 2004, the Voluntary Restructuring of Solvent Insurers Act ("Voluntary Restructuring Law"), dealt with the subject by creating a vehicle whereby solvent Rhode Island-domestic insurers (including those that re-domesticate to Rhode Island) could commute liabilities for commercial property and casualty business in run-off and terminate operations. Despite a 2011 Rhode Island Superior Court case that confirmed certain aspects of the Rhode Island approach *(In Re GTE Reinsurance Company)*, this legislation has not been widely used as potential assuming insurers reportedly have been reluctant to re-domesticate to Rhode Island. Moreover, issues continue to exist under the Voluntary Restructuring Law regarding its legal certainty and enforceability outside of Rhode Island.

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In a Part VII Transfer, the High Court of England and Wales (the "High Court" or the Court of Session in Scotland) orders the transfer and permits UK insurers, as well as certain insurance branch operations of a UK, EEA (European Economic Area) or non-EEA insurer, to transfer books of assets and liabilities (including US non-admitted and reinsurance business) to qualified overseas transferees. Part VII Transfers of liabilities governed by UK law and sanctioned by the High Court have the benefit of finality.

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LIMA, on the other hand, was designed to create a unique niche management industry in Vermont for the run-off of US commercial insurance and reinsurance legacy business written by US and overseas non-admitted (i.e., unlicensed) insurers and reinsurers that would like to exit such business ("Legacy Business"). As discussed below, a transfer pursuant to LIMA ("LIMA Transfer") probably lacks finality.

LIMA has several distinctive features that distinguish it from UK Part VII. These features are:

1. LIMA requires that a Vermont-domiciled company be established specifically to assume Legacy Business. LIMA permits any Vermont entity, including specialized non-insurers, such as investment companies, to be formed to assume Legacy Business. One of the chief industry proponents of LIMA has observed that foundations, institutional endowments, family trusts and other investors with long investment horizons may perceive LIMA as creating an attractive investment opportunity.

2. Unlike UK Part VII which is broad in scope, a LIMA Transfer is restricted to closed blocks of non-admitted commercial property and casualty insurance business and reinsurance. To be considered a "closed block," all such business is required to have been expired for not less than 60 months and have no active premiums yet to be paid. Surplus lines business meeting such requirements and, presumably, direct and industrial insured exemption business if placed with an eligible surplus lines insurer, is a focus of LIMA. Workers' compensation, life, health and other kinds of personal lines insurance/reinsurance are specifically excluded from a LIMA Transfer. The fact that qualifying reinsurance must have had no active unpaid premium outstanding for 60 months may create practical impediment against including reinsurance in the transfer, in light of the possible long-tail of premium payments under some contracts.

3. Key to both the LIMA Transfer and Part VII Transfer processes is that notice of the proposed transfer is required to be given to policyholders and reinsurance counterparties. LIMA and UK Part VII notices, however, differ in potential consequence. Pursuant to LIMA, policyholders and reinsurance counterparties are permitted to opt out of the transfer. A Part VII Transfer may be achieved without permitting parties to opt.

4. The LIMA approval process is solely regulatory. Approval is conferred by Final Order (the "Final Order") of the Vermont Insurance Commissioner (the "Commissioner"), which is appealable to the Vermont Supreme Court. In contrast, the UK Part VII process requires approval of both the UK

domiciliary regulator, the Prudential Regulation Authority, formerly known as the Financial Services Authority (the "PRA") and the High Court.

5. The Final Order issued pursuant to LIMA effects a statutory novation of only those policies and reinsurance agreements in the closed block that have not been excluded from the transfer by opt out or otherwise. The UK Part VII process which, as noted above, requires both PRA and High Court approval of a transfer, effects a court-ordered novation of all policies and reinsurance agreements that comprise the closed block.

6. Unlike UK Part VII, LIMA contemplates that regulatory oversight of the assuming company will be tailored by the Commissioner on a case-by-case basis, and that the Final Order will include the terms and conditions of the oversight of the closed block and operation, management and solvency of the assuming company.

When considering strategies for exiting US legacy business, non-admitted insurers and reinsurers should carefully consider whether (i) an exit mechanism is structured to assure finality; (ii) the transfer would be enforceable in all relevant US jurisdictions; and, (iii) in the case of overseas insurers and reinsurers, the transfer provides the basis for the early termination of US surplus lines or reinsurance trusts which may secure the business to be transferred. An overview of each of these considerations follows:

(i) **Prospective transferors should recognize that finality may not be assured by LIMA.** The objective of exiting a closed block would be defeated by orphan business excluded from a LIMA Transfer by policyholder or reinsurance counterparty opt out. Furthermore, prospective transferors should be alert to the possibility, albeit remote, that the Vermont Supreme Court could unwind a LIMA Transfer on appeal.

(ii) **Whether a LIMA Transfer would be enforceable in all relevant US jurisdictions is unclear.** Courts would apply the constitutional principle of full faith and credit if asked to examine whether a Final Order is enforceable outside Vermont. Article IV, Section 1 of the US Constitution mandates that full faith and credit be given "in each State to the public acts, records, and judicial proceedings of every other state." It is unclear whether a regulatory "Final Order" alone would be recognized and enforced in any other US state without a court order.

(iii) **A LIMA Transfer may be insufficient to support the early termination of a prospective transferor's US surplus lines or reinsurance trusts.** Overseas surplus lines insurers are required to maintain US surplus lines trusts to secure their US surplus lines business. Many such trusts are extant which cover legacy business in run-off. Similarly, an overseas reinsurer of US cedents may maintain letters of credit, funds withheld, a cedent-specific trust or a US multi-beneficiary reinsurance trust to collateralize US ceded liabilities so that its US cedents may take statutory credit for the reinsurances ceded. Transfer of liabilities to an insurer of other entity that has not satisfied the credit for reinsurance or other requirements for termination of trusts or release of collateral may be ineffective for the practical realization of the transfer.

Challenges of Regulation and Oversight of LIMA Transfers

As LIMA has not yet been tested, there are many issues to be resolved by the Vermont Department of Financial Regulation ("DFR") and prospective insurers wishing to attempt business transfers. Regulatory issues are likely to arise if an assuming company is not an insurer. US cedents domiciled in states other than Vermont who are parties to inward reinsurance agreements included in a LIMA Transfer will expect that the assuming company continue to collateralize their reinsurance liabilities by posting letters of credit or by other acceptable means. The associated costs of providing such collateral could be significant.

We expect that the legacy business exit mechanism created by LIMA will evolve, perhaps by regulations promulgated pursuant to LIMA, to ensure that the vibrant niche management industry envisaged by the DFR is realized. ●

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