Workers' Compensation Carve-Out Business

Underwriting and Reinsurance Pools Working Group
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INTRODUCTION

The Underwriting and Reinsurance Pools Working Group (Working Group) was formed in September, 1999 as a result of a number of issues arising from the operation of the Unicover Occupational Accident Pool (Unicover), including underwriting losses sustained and questions about licensing authority, adequacy of current model laws and regulations with respect to the operation of pools, reporting and disclosure of workers’ compensation carve-out business reinsured by a life insurer and risk-based capital implications. The 2000 Charge assigned to the Working Group was as follows:

The Underwriting and Reinsurance Pools Working Group will perform a comprehensive analysis and evaluation of workers’ compensation carve-out business and the operations of underwriting pools and associations, their impact on the insurance and reinsurance marketplace and the extent that current statutory authority may have to be revised to ensure adequate and effective oversight.

This White Paper specifically addresses and provides recommendations as to the Working Group’s position on the following subissues identified in the 2000 Charge:

1. Provide an analysis of life insurers’ participation in reinsurance pools, including an analysis of the extent that life insurers assume workers’ compensation carve-out business (Marketing Analysis).

2. Provide an analysis of state laws and regulations applicable to insurers’ authority to assume business that they cannot write directly (Legal Analysis).

3. Provide an analysis of the extent that property-casualty insurers cede workers’ compensation carve-out business to pool facilities including an analysis of the attachment levels associated with this reinsurance protection (Legal Analysis).

4. Develop annual statement accounting and reporting disclosures for effective oversight of life insurers that assume workers’ compensation carve-out business. The requirements should include such information as interrogatories regarding whether the insurer assumes this business, disclosure of written, assumed and ceded premium volume, identification of the pools involved and where they are licensed, and schedules or exhibits that allow analysis of reserve adequacy for these long-term exposures (Accounting and Reporting Analysis).
MARKETING ANALYSIS OVERVIEW

The Marketing Analysis Subcommittee of the Interested Parties orchestrated voluntary surveys to three different types of organizations (Life Insurers; Pools/Facilities; and Brokers) known to be involved in the workers’ compensation carve-out marketplace. Unicover was not solicited in the survey, as it was the Subcommittee’s opinion that its data would skew the results. Also, since Unicover is no longer an active participant in this marketplace, the Interested Parties felt that exclusion of Unicover data would present a more accurate picture of the current market environment. Employees of the American Council of Life Insurers (ACLI) summarized the results on a confidential basis and the Subcommittee reviewed the summarized data.

The Subcommittee submitted a report to the Working Group in July 2000. The following comments are excerpts from the report’s executive summary:

The Subcommittee believed the response rate was good given the complexity of some of the information being requested. The Subcommittee also believed that generally there were no real surprises in any of the responses. Although the surveys cover a great deal of detail, the following highlights some of the more important points:

- Of the Pools/Facilities responding to the survey, the number of years providing reinsurance for this product ranges from 8 to 14 years with the average being 11. Of the Life Insurers responding to the survey, the number of years providing reinsurance for this product ranges from 5 to 20 years with the average being 13. This would indicate that these organizations have an established track record of providing the marketplace with a stable and responsible alternative to traditional workers’ compensation reinsurance.

- Based on the information provided in the survey responses, the preponderance of carve out programs are in the $500,000 attachment level and higher for Pools/Facilities, and for Life Companies the majority of accounts written are attaching at $1,000,000 and higher. Of the Pools/Facilities and Life Companies responding to the survey, only one organization has attachments at what they refer to as “first dollar”. This organization has had, over the course of 3 years, slow but sustained growth in this attachment area, and in the Subcommittee’s opinion that would also suggest a stable and responsible alternative to traditional workers’ compensation reinsurance. Workers’ Compensation Carve Out Reinsurers provide significant capacity, both on a per person and per occurrence basis, to the primary casualty writers. The Subcommittee noted its importance in California where earthquake peril is substantial. Further along the lines of earthquake risk, life reinsurers would be in a better position to pay workers’ compensation losses than would P&C reinsurers, as life reinsurers would not have the related property losses to address.

- Life Companies/Pools/Facilities provide a variety of carve-out products not found in the traditional P&G arena (i.e., per person, medical only, industrial aid aircraft, transportation-related programs, etc.).

- Reserves are established by the ceding company’s casualty actuary and then reviewed and reevaluated by carve out reinsurers. Based on the information provided, it would appear that the majority of these life reinsurers utilize casualty actuaries for this process.
Based upon responses received from the broker segment of the survey, a significant number (better than half) of the average number of companies purchasing workers’ compensation reinsurance do so in the form of carve out or a combination of carve out and follow form reinsurance. From the results of this same survey, in terms of total workers’ compensation reinsurance dollars spent, on average a fourth is spent on carve out products. This would indicate that the workers’ compensation carve out reinsurance product fulfills a need for primary casualty writers in support of their respective blocks of workers’ comp business.
LEGAL ANALYSIS OVERVIEW

Several parties conducted analyses of the legal issues surrounding life insurers’ authority to assume workers’ compensation carve-out business.

The first review, which was conducted by NAIC staff, consisted of a survey of the states. The survey asked whether the states provide authority for insurers to assume lines of business that they do not have the authority to write directly and whether the authority is granted through law, regulation or by practice of the insurance department. The following comments are excerpts from the survey results:

Survey Response
The survey was sent via facsimile and electronic mail on October 15, 1999 to the chief examiners of the 50 states, the District of Columbia and four territories. A second request was sent on November 8, 1999. Through November 22, 1999, the NAIC has received responses from 42 states and one territory.

Questions Number 1 and 2
Question number 1 asked whether the states provide authority for insurers to assume lines of business that they do not have the authority to write directly. Question number 2 asked respondents that answered yes to question number 1, to document whether the authority is granted through law, regulation or by practice of the insurance department.

Yes   10    23% of respondents
No    33    77% of respondents

Of the 10 states that responded that they allow this activity, the breakdown of how the authority is granted is as follows (note that two states responded that both their law and regulations authorize this activity):

Law    8
Regulation  2
Practice  2

Of the 8 states that grant this authority in statute or regulation, most respondents to the survey cited sections dealing with authorized reinsurance or credit for reinsurance. Several states that responded that they do not grant this authority cited similar sections of law and regulation. Often, the language in the statutes or regulations is identical or substantially similar, so the states apparently interpret these laws and regulations differently.

One state permits affiliated insurers to assume a kind or class of business that it would not be permitted to write directly, subject to prior approval of the commissioner. Two other states responded that their statutes provide authority for insurers to assume kinds or classes of risks that they are not authorized to write directly, if specifically authorized by the commissioner. A third state responded that this authority was not granted in statute even though the statutory language regarding commissioner discretion was identical.

Based on the survey responses, Texas appeared to have addressed this issue most directly. Texas life insurers may, subject to prior approval by the commissioner, assume property casualty business if the life insurer meets certain regulatory requirements. Texas requires that the assuming insurer meet minimum surplus requirements applicable to P&C insurers, file the Underwriting and Investment Exhibits, General Interrogatories, Notes to Financial Statement, 5 Year historical Data, assumed and ceded portions of Schedule F, Schedule P and file actuarial attestation as respects casualty business assumed.
The second review was conducted by the ACLI. The ACLI paper entitled “Authority for Conducting Workers’ Compensation Carve-Out Reinsurance” concluded that life and health insurers are generally authorized by law to assume workers’ compensation carve-out reinsurance.

The Legal Analysis Subcommittee of the Interested Parties conducted the third review. Excerpts from the Subcommittee’s analysis are as follows:

In contrast to the ACLI’s position, some interested persons believe that the February 18, 2000 survey of state laws (prepared by the Reinsurance Association of America (RAA) and previously forwarded to NAIC Legal Staff) supports the conclusion that authority for life and health insurers to assume workers’ compensation carve-out reinsurance is:

- expressly permitted by law in 7 states (CA,IA,LA,NE,NY,OH and OK);
- expressly prohibited by law in 13 states (AK,AR,CT,FL,ID,KS,MD,MT,NJ,OR,SC,SD and VT);
- possibly impliedly prohibited by law in the 17 states which only allow insurers to assume reinsurance of business they are otherwise authorized to insure and which don’t either expressly permit or expressly prohibit life insurers to write or assume workers’ compensation business (AL,AZ,CO,DE,IL,KY,ME,MA,NV,NM,PA,TN,UT,VA,WV and WI); and
- uncertain in the remaining 13 states.

Michael E. Surguine, Insolvency Counsel of the NAIC, completed the final analysis. He submitted the following information to the working group in July, 2000:

The NAIC legal staff was asked to consider the issue of whether life and health insurers have the legal authority to reinsure workers’ compensation carve-out business. Mr. Surguine reviewed the compilation of state statutes and regulations compiled by the RAA, the comments of the Legal Analysis Subcommittee of Interested Parties regarding this issue, the memorandum submitted by the ACLI and the survey performed by NAIC staff in the fall of 1999.

Mr. Surguine did not concur with the ACLI’s conclusion that the majority of states have determined that life and health insurers are authorized by law to reinsure such business. To the contrary, he observed that most of the states have not addressed the question. It appears that only two states, California and Connecticut, have specifically taken a position on the issue. To determine whether a given state’s laws provide such authority in the other jurisdictions, one must read and interpret statutes that do not specifically address workers’ compensation carve-out business and try to deduce a conclusion. This naturally gives rise to the possibility that different analysts, regulators and courts will reach differing results. This is precisely what was demonstrated by the survey conducted by NAIC staff on the issue.

Mr. Surguine also did not feel comfortable accepting the conclusions of the Legal Analysis Subcommittee that the assumption of workers’ compensation carve-out business is expressly permitted in 7 states, expressly prohibited in 13 states, and “possibly impliedly” prohibited in 17 states. Mr. Surguine believes that the state of the law is not as clear as represented by the Legal Analysis Subgroup’s research but does agree with its conclusion that “regulators in each state may wish to seek the advice of local counsel regarding the standard applicable to their domestic life and health insurers.”
ACCOUNTING AND REPORTING ANALYSIS OVERVIEW

The Accounting and Reporting Analysis Subcommittee of the Interested Parties presented a recommendation to the working group that the Life and Accident and Health Annual Statement be amended to disclose material information relating to risks originating in workers’ compensation policies that are ceded and assumed by life and health insurers. The Subcommittee felt that such disclosure was both appropriate and necessary. Accordingly, they recommended the following changes to the 2002 Life and Accident and Health Annual Statement:

A. Create new forms, entitled Workers’ Compensation Carve-Out Products Report Forms (New Forms), to be filed by April 1.

   Contents of New Forms would include:

   1. Exhibit of Workers’ Compensation Products (similar to Schedule H in the Life and Accident and Health Annual Statement)
   2. Schedule of Development of Incurred Losses (similar to Schedule O in the Life and Accident and Health Annual Statement)
   3. Schedule of Assumed and Ceded Reinsurance (similar to Schedule S in the Life and Accident and Health Annual Statement)

B. Add a new question to Supplemental Exhibits and Schedules Interrogatories:

   1. Does your company assume workers’ compensation carve-out business from other insurers?
      [ ] Yes [ ] No

   2. Will the New Forms be filed with your state of domicile and the NAIC by April 1?
      [ ] Yes [ ] No

   If response to first question is yes and response to second question is no, please explain.

   If response to second question is no and response in New Form is “None”, affix bar code (Document Identifier xxx) here:
BASIS FOR RECOMMENDATIONS

This section of the White Paper summarizes the discussions of the Working Group in developing the recommendations that follow this section.

1. First, the Working Group developed a definition of workers’ compensation carve-out business, which follows:

   Workers’ compensation carve-out business is defined as reinsurance (including retrocessional reinsurance) assumed by life and health insurers of medical, wage loss and death benefits of the occupational illness and accident exposures, but not the employers liability exposures, of business originally written as workers’ compensation insurance.

2. The Working Group then considered the form of workers’ compensation carve-out business. It should be noted that the Working Group limited its review to the issues surrounding workers’ compensation carve-out business; therefore, the recommendations included in this White Paper should not be viewed as a precedent for other forms of carve-out business insurers might contemplate. Although life and health insurers write and reinsure similar benefits, such as weekly disability payments, medical expenses and accidental death and dismemberment, the Working Group concluded that in substance, workers’ compensation carve-out is a component of a packaged group of statutory insurance coverages that have risk characteristics associated with underwriting and claims experience comparable to traditional casualty business. The Working Group reached this conclusion by identifying significant differences between workers’ compensation carve-out and traditional health products, including those described in the following outline provided by the American Academy of Actuaries in its letter to the Life Risk Based Capital Task Force dated August 31, 2000:

   A. Benefits Covered

      Group Health - Generally, health service provided within the policy effective period. Co-pay generally required, either fixed dollar amount or percentage, with percentage more common for “indemnity” plans. May also include (limited) rehabilitation costs. Secondary [sic] to workers’ comp. Also subject to subrogation or coordination of benefits with any applicable auto insurance medical coverage or other group health.

      Group Stop-Loss - Health reinsurance or coverage provided to self-insured plans for amounts due under a group health plan (see above) that exceed an attachment point related to a specific individual or the entire plan’s liability during the policy effective period.

      Group Short-Term Disability - Fixed percentage of pre-disability wages for duration of disability or shorter fixed period. Percentage contractually determined. Coverage will generally not cover a disability that is covered by workers' comp insurance.
Group Long-Term Disability - Fixed percentage or fixed amount of pre-disability wages for specified period (may vary by reason for disability). Payment basis is contractually determined and is generally subject to offsets (e.g., Social Security). Coverage will generally not cover a disability that is covered by workers’ comp insurance.

Workers’ Comp Medical - Health services provided as a result of accident during the policy effective period, regardless of when the services are provided or the existence or number of gaps in the service. (Can be lifetime coverage for medical costs arising from the covered accident.) Generally, 100% coverage with no co-pay. Typically includes rehabilitation and in some cases retraining costs.

Workers’ Comp Indemnity - Fixed percentage of pre-accident wages for duration of disability, subject to maximum and minimum, with annual escalation in some states. May also include benefits to widows and dependents that are paid in the event of fatalities. The amount and length of benefits are determined by statute.

Workers’ Comp “Carve-out” Reinsurance - Reinsurance of a portion of the claims of workers’ comp (medical and/or indemnity which likely “becomes” disability reinsurance assumed in a life company). Attachment points generally define the reinsured portion. Originally, these were at very substantial amounts with few as low as $50,000. Recently, the attachment points have gone below $50,000 in some cases.

B. Limitations

Group Health - Varies by contract. Co-pay frequently varies by service provider used. Annual maximums are common. Rehabilitation benefits are capped at a number of visits per year.

Group Stop-Loss - Varies by contract, but generally requires claims to be reported within some fixed period and paid within a number of months of the end of the policy period.

Group Disability - For both short-term and long-term coverage, disability is defined by contract. Definition of disability can vary depending on the length of the disability.

Workers’ Comp Medical - Few limitations. Varies by state. Many states have no limitations for medical costs arising from covered accident.

Workers’ Comp Indemnity - Disability defined by statute and/or state board. Definition consistent over length of disability. Disability must be arising from the scope of employment, as defined by statute and/or state board.

Workers’ Comp “Carve-Out” Reinsurance - Reporting of claims is generally required within seven years of the contract term. There are few or no limits on the period when covered claim payments must be made for these reported claims. Maximum payment is typically based on per occurrence or per person limits subject to an annual aggregate limit.
C. Benefit Payout Differences

Group Health - Nearly all payments made during policy effective period, plus 3-5 months thereafter - longer run-off is frequently related to recovery under subrogation or coordination of benefits.

Group Short and Long Term Disability - Payments made during length of disability.

Workers’ Comp Medical - Payments made during length of medical need, regardless of time lag since the injury. May last the length of disability. Minority of total payments made during policy effective period.

Workers’ Comp Indemnity - Payments made during length of disability. Minority of total payments made during policy effective period.

Workers’ Comp “Carve-Out” Reinsurance - These claims will result from workers’ comp claims involving more severe injuries (higher medical costs) and longer disabilities. Thus, the average payout period will be substantially longer than the average for any of the above.

D. Premiums

Group Health - For large groups, a monthly premium will be developed for a single employee, and per employee with various combinations of dependents based on either the historical experience of the group, the average demographics, or both, plus any changes in the benefits to be provided. Monthly reported premiums will be based on numbers of exposure units of each employee-type times the per unit premium. The enrollment, the existence of employee contributions and the desire of providers to be assured that a claimant has coverage prior to providing some services have forced a rapid reconciliation and updating of actual enrollment. Reported premiums reflect only the modal premium (generally a monthly premium).

Where the group’s premium is adjusted partially or in full for its own experience, the company will establish reserves for experience rating refunds due to favorable experience and will offset unfavorable claims experience with additional amounts due from the insured. For smaller groups, the rating will more closely reflect the changing demographics (age, sex, etc.) of the enrollees during the year. As such, there are retroactive changes to the reported premiums but states do not generally allow experience adjustments for small groups.

Group Stop-Loss - The rating basis is similar to group health. However, to reduce administrative costs, the reporting is generally not as intense. The reported amounts include a greater reliance on estimates with reconciliation of several months’ changes occurring at one time.

Workers’ Comp Medical and Indemnity - Underlying policy premium combines medical, indemnity and employers liability for one indivisible premium. Annual premium is derived by multiplying payroll (by job classification) by a rate, summing the resulting products across all job classifications, then multiplying by size (expense-related) discounts and (prospective) experience rating factors.

Workers’ Comp “Carve-Out” Reinsurance - Reinsurance premiums for workers’ comp are generally based on a percentage of the calendar year reported earned
premium. The percentage is negotiated to reflect the attachment point, deductibles, policy limits and other provisions of the reinsurance contract.

Based upon the differences in benefits covered, limitations, benefit payouts and premiums, the Working Group rejected the Interested Parties’ recommendation to use “life-like” schedules in the Annual Statement Supplement and opted to recommend the use of “property-casualty like” schedules. The Working Group also concluded that reporting and accounting disclosures should follow those pertaining to the business originally written by the direct writer (see recommendation 3).

3. In light of the NAIC’s efforts to implement regulatory initiatives on financial modernization, the Working Group’s recommendations focused on uniformity and consistent implementation amongst the states. The recommendations are consistent with the goals of the Accelerated Licensure Evaluation Review Team (ALERT) Working Group with respect to the uniform application process for company licensing and elimination of state-specific requirements that add no regulatory value.

4. The Working Group believes that the appropriate attachment level correlates directly with the assuming entity’s level of expertise and experience reinsuring workers’ compensation carve-out business. Since life and health insurers have successfully reinsured this type of business at high or catastrophic attachment levels for approximately 20 years, the Working Group feels this business should be assumed at those levels. The Working Group, however, is sensitive to the fact that certain companies may have the expertise and financial capacity to assume at lower levels. If a company desires to reinsure workers’ compensation carve-out business at lower levels, it should be able to do so if its domestic regulator agrees with the decision.
RECOMMENDATIONS

The Underwriting & Reinsurance Pools Working Group believes that life and health insurance companies should be permitted to reinsure workers’ compensation carve-out business, subject to a satisfactory demonstration to their domestic regulators that they have the required expertise to underwrite workers’ compensation carve-out and proper reporting and disclosure of the business.

1. The Working Group recommends that each state review its legal framework to identify whether workers’ compensation carve-out business is explicitly allowed or disallowed. In order to encourage a uniform approach, the Working Group suggests that each state incorporate into its legal framework any additional provisions which may be necessary to allow life and health insurance companies to reinsure this business. The Working Group also recommends that each state notify its domestic industry of the requisite authority and other requirements to reinsure workers’ compensation carve-out business. As indicated in the surveys referenced above, life and health insurers are currently engaging in this line of business (whether or not they are doing so under explicit statutory authority) and therefore, it is important to put such companies on notice as to the state’s plans.

2. The Working Group recommends that states view workers’ compensation carve-out business as “occupational accident” in order to grant a life and health insurance company the specific authority to reinsure it, and that the requisite authority be considered a subset of accident and health.

3. The Working Group recommends that this business be conducted at a high attachment level unless the company can demonstrate to its domestic regulator that it has considerable experience and expertise. As noted in the surveys, the majority of property and casualty companies cede workers’ compensation carve-out business as part of their catastrophic models. The Working Group believes that each domestic regulator should review the appropriateness of the attachment layer assumed by the company during its detailed analysis of the entity’s application. If a state believes the company does not possess the required expertise to assume “first dollar” or low attachment coverage, the regulator should require higher attachment levels.

4. All life and health insurance companies that are currently reinsuring or desire to reinsure workers’ compensation carve-out business should complete a demonstration of due diligence. Companies already licensed to transact accident and health business should submit a Workers’ Compensation Carve-Out Business Plan to their domiciliary states. Companies not currently authorized to write accident and health business must apply for that line of authority in accordance with domiciliary state requirements in addition to submitting a Workers’ Compensation Carve-Out Business Plan. An officer of the company who has knowledge of the facts set forth in the Plan must provide signed verification of the company’s operations.
If the submission is approved, the domiciliary commissioner will issue a Letter of No Objection to the insurer. The company will in turn file the letter with all states in which it is licensed or approved as a qualified reinsurer.

In reviewing a company’s Workers’ Compensation Business Plan, the domiciliary state will consider the following information:

a. Company profile, including management, organizational structure and financial results. This information should already be on file with the domiciliary state and need not be resubmitted unless material changes have occurred during the interim period.

b. The *Workers’ Compensation Carve Out Business Plan* should include the following:

i. Biographical information on the individuals who will be responsible for the management of the workers’ compensation carve-out business.

ii. A detailed description of the following:

- the method of participation in the business - directly or through pools. If participation is through a pool, the company should include a discussion of previous experience with underwriting and reinsurance pools;
- the company’s past experience assuming or ceding this line of business;
- the standards, procedures and controls for the management of the workers’ compensation carve-out business; and
- the planned attachment levels for this business and the reasons supporting the selection of such attachment levels.

iii. An explanation as to how the workers’ compensation carve-out contracts will be priced.

iv. Identification of the entity that will perform the underwriting and the claims adjusting and payment functions.

c. Pro-forma projections of operating results for the workers’ compensation carve-out line of business, including the assumptions used in deriving the projections, along with actual results if available.

d. Identification of the actuary who will be responsible for establishing the reserves for the workers’ compensation carve-out line and a description of his/her qualifications and expertise in establishing reserves for this business.
5. The insurer should comply with the disclosure requirements as stipulated in the *Workers’ Compensation Carve-Out Supplement*. This supplement includes schedules and exhibits that were modeled after the Property & Casualty Annual Statement including:

a. Underwriting and Investment Exhibit, Part 1 – Premiums Earned  
b. Underwriting and Investment Exhibit, Part 2 – Premiums Written  
c. Underwriting and Investment Exhibit, Part 3 – Losses Paid and Incurred  
d. Underwriting and Investment Exhibit, Part 4A – Unpaid Losses and Loss Adjustment Expenses  
e. Schedule F – Part 1 – Assumed Reinsurance as of December 31,  
f. Schedule F – Part 2 – Ceded Reinsurance as of December 31,  
h. Additional interrogatories detailing premium volume of workers’ compensation carve-out line
CONCLUSION

This White Paper represents the culmination of numerous NAIC National Meetings, interim meetings, and various conference calls. Throughout, Interested Parties were afforded numerous opportunities to provide commentary to assist regulators in the development of this White Paper. The public’s input into the issues surrounding this paper has been crucial to reaching a balanced conclusion.

Clearly, it is impossible to suggest that the recommendations included in this White Paper would prevent another “Unicover” incident. Nevertheless, public confidence in these transactions can only be attained if they are subjected to thorough regulatory review. The decision to proceed with a uniform approach to permit life and health insurers to reinsure workers’ compensation carve-out must receive positive support from both individual insurers and regulators. Therefore it becomes imperative that life insurers must satisfactorily demonstrate to the regulators that they have the required expertise to assume workers’ compensation carve-out business. Continuing insight will be gained as additional transactions are considered. This White Paper provides recommendations on critical issues to give regulators guidance to thoughtfully scrutinize these transactions and to monitor the underwriting and claim experience. Such guidance is critical for the protection of policyholders and efficient operation of the insurance market. It should be noted that the Working Group limited its review to the issues surrounding workers’ compensation carve-out business, therefore, the recommendations included in this White Paper should not be viewed as establishing a precedent for other forms of contemplated carve-out business.