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Acquisition of Control of U.S. Insurance Companies

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Acquisitions of “control” of U.S. insurance companies entail working through the insurance industry’s unique regulatory and execution intricacies. Generally, if a person acquires ten percent or more of the voting securities of an insurance company, either directly or through the acquisition of similar interests in one or more intermediate entities, it will be considered to be acquiring a “controlling” interest in the insurance company.

Insurance companies in the U.S. are regulated primarily at the state level, by the insurance regulators of their respective states of domicile. In order to acquire control, the state insurance laws require that an acquirer obtain prior approval for the acquisition of control from the insurance regulator in the state where the insurer is domiciled. Often, in connection with the acquisition, other related approvals are required from the insurance regulator, including approval for transactions, related dividends and affiliate transactions. These required approvals often affect the structuring, financing and documentation of insurer acquisitions. The focus of this article is to outline the major legal considerations involved in the stock acquisition of an insurer, and by necessity, it approaches these topics at a high level.

Acquisition of Control of U.S. Insurance Companies

1. Means of Acquisition

Control of U.S. insurance companies is typically achieved via a stock acquisition; whereas, the business of insurance companies (rather than control of an insurance company itself) can be acquired through an asset sale, bulk reinsurance transaction, assumption and novation, or renewal rights transaction. In addition, recently enacted state insurance laws allowing for insurance company divisions and business transfers are emerging as new tools for the acquisition of insurance companies.

Agreements for U.S. insurance carrier acquisitions should differ from those in other industries; for example, insurance carrier purchase agreements typically include some specialized representations and warranties. These include, among others, representations as to statutory financial statements, the possession of relevant licenses, the making and accuracy of required regulatory filings, the due appointment of agents and compliance with other regulatory requirements. These representations are generally fairly uncontroversial. A specialized representations and warranties topic that is sometimes a source of controversy is the target company's loss reserves. The calculation of loss reserves is part art and part science, and at any time the amount reflected on the target's books is likely greater or less than, but not exactly equal to, the amount actually needed to settle all claims. As a result, reserve representations are generally careful to specify that they do not guarantee that the amounts provided will be sufficient to pay all eventual losses, but rather will focus on the process by which the reserves are calculated. In fact, it has become quite common for sellers to expressly disclaim any representation as to the adequacy or sufficiency of reserves for policyholder and related liabilities as they develop over time.

The insurance business is much more heavily focused on long-term assets and liabilities; insurers receive premiums and invest them in investment assets, which they hold for years to support long-term reserves established to pay losses and related expenses. As a result, a typical closing adjustment in an insurance carrier deal is based on a measure of total capital, often statutory net worth, but sometimes risk-based capital or another specialized measure.

A key provision in an insurance carrier purchase agreement is the "regulatory efforts" clause. As discussed below, the acquisition of a U.S. domestic insurer must be approved by its domestic state insurance regulator. Insurance carrier purchase agreements generally seek to define what level of effort a buyer must make to obtain regulatory approvals, and in doing so what sorts of conditions a buyer and its affiliates must accept. The most stringent form of regulatory efforts clause is a "hell or high water" clause, which requires a buyer to take any and all steps a regulator requires. While this formulation is occasionally seen in transactions in connection with antitrust clearances, it is extremely rare in respect of insurance regulatory approvals. Much more common is some version of a reasonable best efforts provision. This type of clause is often bounded by a limit that no party shall be required to accept any regulatory condition that would amount to a "burdensome condition" (or sometimes, that a party must accept anything and everything short of a "burdensome condition"). The imposition of a burdensome condition generally permits a party to refuse to close the deal. It is unusual to include any express quantitative measure of harm that would constitute a burdensome condition. Parties find this sort of quantification hard to agree to beforehand; moreover, there is sometimes a concern that providing a specific measure will encourage a regulator to ask for something just short of that level.

2. Determining Whether "Control" of a U.S. Insurance Company Has Been Acquired

a. Definition of Control

Acquiring a U.S. insurance company presents unique obstacles to any investor, particularly if the investor will obtain "control" of the insurer. The definition of control in the various insurance holding company acts is not typically very precise. The NAIC Model Insurance Holding Company System Regulatory Act (the "***Model Act***"), which has been adopted in whole or in part in all states, says that control means "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or nonmanagement services, or otherwise." The Model Act goes on to say that "[c]ontrol shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing, ten percent or more of the voting securities of any other person," although that presumption may in appropriate circumstances be rebutted by a showing that control does not exist in fact.

Over the years, numerous state insurance regulators have put their own glosses on the definition of control, which do not always line up exactly with the words of the relevant statute. These interpretations also cover situations in which the ten percent presumption may be rebutted and requirements for such rebuttals. In each case, however, if "control" would exist, its acquisition may not occur without preapproval. As such, if an investor acquires ten percent or more of the voting securities of an insurance company, it is deemed to have acquired a "controlling" interest and will need to receive approval from the insurance regulatory authority of the state in which the insurance company is domiciled.

b. Control of Voting Securities vs. Nonvoting Securities

As described above, under the Model Act, the holder of ten percent or more of the voting securities of an insurance holding company is presumed to be in control. In many states, the term "voting securities" can include convertible securities; therefore, holders may need to aggregate their positions in common stock, convertible preferred and even convertible debt for purposes of evaluating whether they reach the ten percent threshold. Rebutting this presumption of control generally requires filing a disclaimer of control (as described more fully below) with the applicable authorities and having it approved. One of the key items that insurance regulators consider in determining whether to approve a disclaimer of control is whether the holder has representation on the board of directors of the insurer or its holding company.

It is important to understand that the focus of the concept of "control" is on an insurance company's voting securities. The acquisition of control of ten percent or more of an insurance company's nonvoting securities without any other indicia of control such as a board seat is not sufficient to make the acquirer a "control" person. By way of example, if a corporation owns fifty percent of an insurance company's nonvoting stock, that corporation should not be considered to be a control person of the insurance company. Conversely, acquiring ten percent or more of the voting securities of an insurance company will trigger the rebuttable presumption. For example, a limited liability company, which owns ten percent of the voting stock of a corporation, which in turn owns ten percent of the voting stock of the insurance company, is considered to be a "control" person of the insurance company just as the corporation is considered to be a "control" person of the insurance company.

c. Disclaimer of Control

The Model Act presumes that control has been acquired when a person obtains ten percent or more of the voting securities of a target. Unless this presumption is rebutted, each acquirer of ten percent or more of the voting securities will have to provide financial statements and the other items discussed below as part of their filing. Depending on the facts of the situation, a smaller holder may be able to file a "disclaimer of control," to effectively rebut the presumption and avoid filing a full Form A.

Disclaiming control is more likely to succeed where, for example, there is one majority holder that clearly has the power to control the affairs of the insurer as a practical matter; in such case, a smaller holder with not much more than ten percent of the voting securities and limited board representation is often able to disclaim control. Therefore, potential investors who are purely passive economic investors that trigger the presumption of control in insurance companies are generally able to submit disclaimers of control filings to avoid being treated as "control" persons of those companies. The disclaimer of control filing sets out the facts that demonstrate the passive nature of the proposed investment. Approval of a disclaimer of control is a question of facts and circumstances as to whether the shareholder in fact is in a position to exert control over the insurer.

3. Acquiring "Control" of a U.S. Insurance Company

a. The Form A Application

As mentioned above, in order to acquire control of a U.S. insurance company, the investor will need to file an application for approval of the acquisition of control with the insurance regulatory authority in the insurance company's state of domicile, also known as a "Form A." The Form A requires detailed information about the acquirer, its management, its financial condition, the terms of the transaction, and other items allowing the regulator to evaluate the merits of the transaction.

Because insurers, by the nature of their business, make long-term promises to pay money, much insurance regulation is devoted to ensuring that they will be able to keep those promises. Therefore, the Form A is a substantial filing, which state insurance regulatory authorities generally take several months to evaluate. In considering an acquisition of control, regulators will evaluate whether the plans or proposals of the acquirer are unfair and unreasonable to policyholders, the competence, experience and integrity of the acquirer, and whether the acquisition of control is likely to be hazardous or prejudicial to the insurance-buying public and not in the public interest.

These considerations are meant to determine whether the buyer might directly or indirectly harm the financial well-being of the insurer. The past business conduct and current business operations of the buyer are also relevant considerations.

b. Content in the Form A

The Form A application must include, among other elements, (i) a description of the transaction and copies of all major transaction documents; (ii) identification of all applicants, which are the investor entities that are acquiring control and the entities or individuals that control them; (iii) identification of all directors and executive officers of each applicant, as well as any new individuals who will become directors and executive officers of the insurance company or any intermediate holding company; (iv) audited financial statements of the applicant(s) and if the applicant is an individual some type of personal financial statement or net worth affidavit; (v) a description of the purchase price and the method for financing the transaction, which is carefully reviewed by regulators because regulators do not want the holding companies overly leveraged and needing dividends from insurance companies for debt service; and (vi) a description of the future plans for the insurer following the acquisition, including generally three-year *pro forma* statutory financial projections for the insurer.

Directors and executive officers of each applicant, as well as any new individuals who will become directors and executive officers of the insurance company or any intermediate holding company must provide NAIC-form biographical affidavits and, depending on the state, fingerprints to the department. These materials are used to conduct criminal background checks and other verification procedures to ensure that management has the requisite integrity and credentials to lead an insurance company. The completion of the biographical affidavit and fingerprinting is involved and needs to be carefully done since the answers are being verified by a background check company. Thus, investors need to carefully coordinate this process. Directors and executive officers often live in locations remote from the acquirer's headquarters; therefore, obtaining their respective input, signature and fingerprints poses challenges as does the remote work environment. Not to mention the fact that responses to biographical affidavits sometimes implicate facts from the director's or executive officer's past that may be sensitive, such as personal lawsuits or suspension of a professional license.

Additionally, the future plans item of the Form A occasionally requires time and effort. In an acquisition where business and operations will largely remain unchanged, it is usually sufficient to state in the Form A that no significant changes are anticipated. However, in some cases, the regulator may seek quantitative/narrative evidence that the transaction will have no immediate impact on the insurer. In many cases, sellers will need to provide a *pro forma* financial statement showing both the balance sheet and income statement impact of the acquisition over a specified period of time (*e.g.*, three or five years). Further, the acquiring party must indicate if changes in the day-to-day management of the insurer, such as outsourcing of certain functions that historically have been handled in-house or by other service providers (*e.g.*, investment management, underwriting, claims-handling, etc.) are contemplated.

c. The Form A Hearing and Approval/Non-disapproval

Most states' versions of the Model Act allow the regulator to hold a hearing on the Form A, which is typically a public hearing. The Form A hearing is required prior to *disapproving* a Form A but is not necessary to approve the Form A. Thus, some states regularly have public hearings on Form A filings and others do not. Form A hearings will be scheduled only when the regulator has deemed the Form A complete, which will be when all questions and comments from the regulator have been addressed to his or her satisfaction and the applicant has supplied all written materials requested in support of the Form A.

At the hearing, the applicant will advocate for the Form A, and call at least one witness to testify to the merits of the transaction. The applicant's job is to establish that the acquisition satisfies the criteria for approval. The department staff may cross-examine the witness and may present its own testimony as to how it conducted its review. The department's questioning is typically not adversarial and is really designed to demonstrate to the hearing officer its thoroughness in reviewing the Form A. It is worth mentioning that in very unusual circumstances, third parties demonstrating an interest in the transaction may seek to make statements or even intervene in the Form A proceeding. After testimony and evidence are heard, the record is closed and the hearing is adjourned. The parties will then wait for the commissioner's determination, which is generally received within thirty (30) days of the hearing.

Under the Model Act, a regulator must approve the acquisition of control unless: (i) the domestic insurer would not be able to satisfy the requirements for licensing after the deal; (ii) the transaction would substantially lessen competition in the state; (iii) the financial condition of the acquirer might jeopardize the financial stability of the insurer; (iv) the acquirer's plans for the insurer are unfair to its policyholders and not in the public interest; (v) the competence, experience and integrity of those persons who would control the insurer are such that it would not be in the interests of the policyholders and the public to permit the acquisition; or (vi) the acquisition is likely to be hazardous or prejudicial to the insurance-buying public.

Plainly, this standard emphasizes the protection of policyholders, hence regulators' focus on the business plans, projections and *pro forma* financial statements filed with the application (to ensure a continued strong financial profile), as well as the experience and integrity of the persons who will obtain control, and the proposed directors and executive officers of the target and its controllers after the closing.

Outright rejections of Form A applications are rare, but they do happen, mainly where the principal control person has had significant legal troubles bearing on his or her character and fitness to control a regulated financial institution, if the exact identities of the members of the proposed control group are not clear or if there are competition problems arising from the acquisition. Much more common is for regulators to impose conditions on a change of control. These may include reserves strengthening, maintaining a targeted risk-based capital level, enhanced limits on dividends, enhanced limits on affiliate transactions, capital contributions, funding of trusts, keepwell agreements, and more. *See* the NAIC Financial Analysis Handbook for reference to certain conditions imposed.

4. Confidentiality Concerns

A Form A is generally regarded as a public document, and acquiring persons that have not completed deals in a regulated industry may be unaccustomed to a Form A's disclosure and regulatory requirements, including disclosure of personal financial statements. Therefore, it is important to note that financial statements and other sensitive items can generally be provided on a confidential basis.

Regulators typically grant requests to shield portions of the Form A as confidential or proprietary. Sensitive biographical information, for instance, is always confidential. Financial statements of an applicant entity, if not otherwise public, are often treated as confidential, if that is requested. By contrast, requests to treat the purchase price or other terms in the purchase agreement as confidential are typically not granted.

Acquiring persons are sometimes concerned that their limited partners' identities may have to be disclosed to regulators, or even that those partners might have to join in Form A filings. Absent unusual circumstances, limited partners that are passive investors, and have only normal protective provisions under fund documents should not be required to file a Form A; even if they hold more than ten percent of the limited partnership interests, regulators usually do not require them to do so. However, regulators have sometimes asked to know their identities and the percentages of limited partnership interests they hold. These disclosures are likewise generally confidential or can be made on a confidential basis.

5. Additional Regulatory Filings

a. Form E Notifications

Over half of the U.S. jurisdictions have adopted Section 3.1 of the Model Act, which calls for a "Form E" filing in the insurer's non-domiciliary states, in order to evaluate whether such an acquisition will have an anticompetitive impact on the state's local insurance marketplace. Based on the NAIC template, these filings are essentially antitrust examinations, which examine the combined market share following a potential acquisition of the insurance company and the acquirer, in each line of business written by the insurance company in that state. However, if the change in concentration is *de minimis*, no Form E is required. Generally, statutes that govern Form E notifications do not require filings where (i) the combined market share of the involved insurance companies would not exceed five percent of the total market in a given line of business; (ii) the acquisition in question would not result in any increase in any market share for any line of business; or (iii) the combined market share of the involved insurance companies would not exceed twelve percent of the total market for a given line of business, nor would the market share increase by more than two percent of the total market for such line of business.

The Form E requires the filer to detail the lines of business that will become more concentrated in the state as a result of the acquisition. If the amount in a given line is below the quantitative threshold indicated above, the applicant may conclude that there is no anticompetitive effect. If, however, in one or more lines of business, the concentration level will increase by more than the threshold specified above, the applicant must explain in the Form E why the transaction is not anticompetitive. The acquirer might provide quantitative or statistical evidence, or explain differences between the products of the two deal parties, to rebut the presumption. For instance, to mitigate the anticompetitive concerns, a potential investor could discuss (i) the market shares of other market participants, (ii) the volatility of ranking of market leaders, (iii) the number of other competitors in the market, (iv) how concentrated a line of business is, and (v) ease of entry and exit into the market. If the Form E is not disapproved by the regulator within thirty (30) days following submission, the transaction may proceed.

b. The Form D: Prior Notice of a Transaction

Material transactions between an insurance company and any entity that controls it, or is under common control with it, are subject to a Form D Prior Notification filing before they can be entered into. Insurance company acquisitions frequently involve one or more concurrent transactions between the target insurer and an affiliated entity. Sometimes the buyer will seek to have a portion of the target's business reinsured to an affiliate of the buyer as part of the sale. Also, financial sponsor buyers sometimes desire to have the target insurer enter into other types of arrangements with buyer affiliates, such as investment management arrangements, investments in affiliated hedge funds or other vehicles, other service agreements and tax-sharing agreements. These agreements, or adding an insurer to an existing agreement, are subject to a Form D. The Form D will include the text of the proposed agreement and a description thereof.

The Model Act calls for all service agreements, and for reinsurance agreements over a certain size, to be submitted to the domestic regulator, to provide a thirty (30) day opportunity for the regulator to review and, if it determines, disapprove before the agreement becomes effective. Such agreements must have charges for services performed that are "reasonable," and have terms that are "fair and reasonable." The regulator in its review will also determine whether such agreements will adversely affect the interests of policyholders.

c. Annual Filing of Forms B and F

Upon completion of the transaction, the acquirer will become subject to ongoing compliance requirements in the insurer's state of domicile, *e.g.*, the provision of information about the ultimate controlling person and all of its subsidiaries must be filed annually by the insurance company in the Form B Registration Statement. Additionally, in many states, the ultimate controlling person of an insurance company is required to file a Form F Enterprise Risk Report that discusses the material risks within the ultimate controlling person's corporate structure that pose enterprise risk to the insurance company.

If you have any questions regarding this article, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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