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other tax topics relevant to the insurance industry. Recent lectures have included "Company Tax and Audit Update," Life Insurance Council of New York (2009); "Corporate Restructuring," Insurance Tax Conference (2009); "Tax Aspects of Transactions," Life Insurance Council of New York (2008); "Mergers and Acquisitions – Selected Issues and Developments," Insurance Tax Conference (2007); "Life Insurance Company Financings," Life Insurance Council of New York (2006); and "Not-for-Profit Incorporation," The Legal Aid Society (2002-2011) Mr. Rosen is co-author of "XXX Reserve Funding is Debt for Federal Tax Purposes," *Taxing Times* (September, 2009). He has served as Chair of both the Council on Taxation and the Committee on Taxation of Corporations of the Association of the Bar of the City of New York, as a Member-at-Large of the Executive Committee of the New York State Bar Association's Tax Section and as a member of the Committee on Insurance Companies of the American Bar Association's Tax Section. He received the Legal Aid Society's Award for Outstanding Pro Bono Service in 2003 for his work teaching young lawyers how to counsel not-for-profit entities. He graduated *magna cum laude* from the University of Pennsylvania and *cum laude* from New York University Law School, where he was an Executive Editor and Book Review Editor of the *New York University Law Review* and a member of the Order of the Coif.

John M. Vasily is Co-Chair of the firm's Financial Institutions Group and focuses his practice on cross-border merger and acquisition transactions in the insurance and financial services sector, including in Asia and Latin America. Mr. Vasily was selected as a "Dealmaker of the Year" by *The American Lawyer* in 2011. *Chambers USA* (2012) ranks Mr. Vasily as a leading lawyer for Financial Services M&A.. He is also recognized by the *IFLR1000* (2012) as a leading lawyer for both Mergers and Acquisitions and for Financial Services Regulatory matters, by *The Legal 500 US* (2012) as a leading lawyer, and by *IFLR Expert Guides* (2012) as a leading M&A lawyer. Mr. Vasily is an adjunct professor of law at Georgetown University Law School, lecturing on international securities laws. He received his undergraduate degree from Villanova

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FOREWORD

TRANSACTIONAL TRENDS IN THE GLOBAL INSURANCE M&A MARKET

Corporate mergers and acquisitions are having an important impact on the global insurance market in 2012. These transactions take place against a backdrop of regulatory changes, continuing low interest rates, distress in Europe and, for some financial institutions, the obligation to repay government bailout money. These factors have driven insurance companies, other financial institutions and private equity and hedge fund asset managers to look to the M&A market as they divest non-core assets, consolidate operations and reconsider doing business in certain geographic areas. This M&A activity has been coupled with other transactions across the capital spectrum, including reinsurance and capital markets transactions, as insurance companies seek to manage their own capital needs in the most efficient and effective manner possible.

This Foreword surveys transactions that reflect these trends, and considers what might lie ahead in the global insurance M&A market.

REPAYMENT OF GOVERNMENT AID AND OTHER FALLOUT FROM THE FINANCIAL CRISIS:

Financial institutions that received government assistance during the crisis are divesting assets in an effort to pay governments back. Examples abound. In the United States, AIG sold a number of its businesses after receiving government aid during the crisis, including, among others:

- AIG Finance (Hong Kong) Limited to China Construction Bank in 2009;
- American Life Insurance Co. ("Alico") to MetLife in 2010;

- AIG Star Life Insurance Co., Ltd. and AIG Edison Life Insurance Company to Prudential Financial, Inc. in 2011; and
- Nan Shan Life Insurance Company, Ltd. to Ruen Chen Investment Holding in 2011.

AIG also spun off its Asian life insurance business, AIA, in October of 2010. AIA is now a player itself in M&A transactions, agreeing in September 2012 to purchase a stake in Sri Lanka-based Aviva NDB Insurance Plc and in October 2012 to acquire ING's Malaysian insurance subsidiaries.

AIG has made great progress repaying the U.S. government. In May 2011 the Treasury began selling the shares of AIG stock that it received in exchange for its financial aid. The Treasury announced in September 2012 that, so far, it and the Federal Reserve Bank of New York have earned a combined profit of approximately $15.1 billion (giving effect to the most recent offering) from their commitment to AIG. The Treasury still holds about 16% of AIG's stock.

In addition to AIG, The Hartford Financial Services Group, Inc. received U.S. government aid during the financial crisis. The Hartford repaid this money in 2010, but its business model, in particular its emphasis on the variable annuity business, has caused continuing difficulties. John Paulson, manager of one of The Hartford's shareholders (hedge fund Paulson & Company), pressured The Hartford to spin off its P&C business in order to unlock value. The Hartford instead announced that it would divest certain assets in an effort to focus on its property and casualty, group benefits and mutual funds businesses. Since this announcement, The Hartford has entered agreements to sell its individual annuity new business capabilities to Forethought Financial Group, its broker-dealer, Woodbury Financial Services, to AIG, its retirement plans business to MassMutual and its individual life business to Prudential Financial.

Repayment of government aid has also driven recent M&A activity in Europe. The Dutch financial institution ING received Dutch government aid in 2008, and, in its repayment plan, agreed to sell its

insurance business by 2013. ING sold its Latin American insurance operations to Grupo de Inversiones Suramericana in 2011, is planning an I.P.O. of its U.S. life insurance operations, and is in the process of selling its Asian life insurance businesses (as mentioned above, AIA recently agreed to acquire ING's Malaysia operations). AEGON, another Dutch company, also received government assistance and repaid this aid in part through the sale of its U.S. reinsurance unit, Transamerica Reinsurance, to SCOR in 2011.

The Royal Bank of Scotland, which received assistance from the British government in 2008, has also been repaying the money it received. As part of the terms for receiving aid, The Royal Bank of Scotland is required to divest its insurance business and has offered shares of its Direct Line Insurance Group in an initial public offering in October of this year.

EVOLVING VIEWS OF GLOBAL DIVERSIFICATION

Insurance companies are reevaluating their presence overseas as views of global diversification change. Taiwan, once considered a desirable market, is now saturated and foreign insurers have been selling businesses on the island. New York Life, AIG, MetLife and MassMutual have all sold their Taiwan interests, and Aviva Plc announced in July 2012 that it would look to exit the Taiwan market as well.

In contrast with Taiwan, insurers are moving into Latin America and Russia. New York Life's focus on its life insurance and investments businesses opened the door for ACE Group to diversify its Mexico business by purchasing a surety bond business, Fianzas Monterrey. Similarly, HSBC's plan to sell non-core businesses has provided opportunities for acquirers in Latin America. QBE Insurance Group Limited, an Australian company, acquired HSBC's general insurance business in Argentina, and AXA Group acquired HSBC's general insurance portfolio in Mexico. QBE and AXA also each entered into 10 year bancassurance agreements with HSBC. The agreements provide

that AXA will be the exclusive provider of property and casualty products to HSBC customers in Mexico and QBE will be the exclusive provider of general insurance products to customers of HSBC Group in Argentina. In October 2012, Principal Financial Group agreed to purchase A.F.P. Cuprum, S.A., a leading pension manager in Chile. Other recent acquisitions in Latin America include U.K.-based RSA Insurance Group PLC's purchase of two Argentine insurance companies, Aseguradora de Creditos y Garantias and El Comercio Compania de Seguros.

As noted above, Russia is another growing market in which insurance groups are looking to expand. For example, Liberty Mutual entered Russia's property and casualty insurance market in March of this year with its acquisition of 99.99% of KIT Finance Insurance, the Russian insurance company.

Another change to the global landscape is Japanese insurance companies now looking beyond Japan's borders for growth opportunities, a trend that had not been seen for some time. Recent examples include Tokio Marine Holdings Inc. acquiring two U.S. based companies (Delphi Financial Group Inc. in May 2012, and Philadelphia Consolidated Holding Corp. in December 2008), and Nippon Life Insurance acquiring a 26% stake in the Indian life insurer Reliance Life Insurance, a deal which was announced in March 2011. In addition, Mitsui Sumitomo purchased New York Life's joint venture stake in Max New York Life, an Indian life insurance company.

BERMUDA

Bermuda is another region generating M&A activity. Although traditional strategic deals, where an insurance company acquires another insurance company, are still getting done, in recent years alternative asset managers have also become active in the market, both through acquisitions and by starting their own reinsurance companies.

Recent examples of the traditional deals include the acquisition by U.S.-based CNA Financial Corporation of Hardy Underwriting Bermuda Limited, U.K.-based Canopius Group Ltd.'s acquisition of Omega Insurance Holdings Ltd., Bermuda-based Validus Holdings Ltd.'s acquisition of Flagstone Reinsurance Holdings and Goldman Sachs Group's purchase of Ariel Reinsurance's Bermuda-based insurance and reinsurance operations. The Goldman/Ariel Re transaction added significant scale to Goldman's property and casualty reinsurance business, which it has operated since 2005.

Bermuda-based Athene Holding Ltd., backed by private equity firm Apollo Global Management, is an example of the second trend. In July 2012, Athene Annuity & Life Assurance Co. (a subsidiary of Athene Holding), agreed to acquire Presidential Life Corp. Presidential sells fixed annuity, life, accident and health insurance products. Athene has purchased other annuity businesses, including Investors Insurance Corp. from SCOR in 2011, and serves as a good example of asset management firms looking to increase their assets under management by purchasing spread-based annuity businesses.

The third trend in Bermuda is hedge funds forming their own reinsurance companies. Hedge fund-backed Greenlight Capital Re was formed in the Cayman Islands in 2004 and paved the way for the recent start-ups in Bermuda. In the past year, three hedge funds started Bermuda reinsurers: Third Point LLC started Third Point Reinsurance, Paulson & Co. started PaCRe Ltd., and SAC Capital Advisors LP started SAC Re Ltd. These start-ups all share a focus on low-volatility reinsurance lines and an emphasis on innovative asset management.

The Bermuda market still has numerous mid-size players, which may lead to further consolidation.

LOOKING AHEAD:

Looking forward, the current regulatory and economic climate will have an impact on M&A activity and the landscape of the global insurance

industry. In particular, Solvency II may be a large driver for future M&A activity for European insurers, as new capital and risk management requirements lead companies to exit certain lines of business. However, there is uncertainty about the timing of the new rules, as the European Parliament has pushed back its vote to March 2013. If the Solvency II start date is also postponed, it may well forestall some M&A activity, causing companies to hold off from entering into transactions as they wait for the final legislation. And, as always in the insurance industry, M&A activity could be spurred by catastrophes, whether they are man-made – as in the European debt crisis – or not.

The emergence of asset managers as a source of buy-side M&A activity, the need to address changing capital requirements, the desire to deploy capital in high growth markets, and the steady increase in bancassurance activity all have given rise to a busy 2012 in the insurance M&A market, and we expect the activity to extend into 2013. We hope that this book will be useful to you as you consider the challenges and opportunities of the M&A marketplace going forward.

November 14, 2012

CHAPTER ONE — ACQUIRING A LISTED INSURANCE GROUP

JEREMY HILL, ETHAN T. JAMES, THOMAS M. KELLY, NICHOLAS F. POTTER AND WILLIAM D. REGNER[1]

This Chapter will briefly outline legal issues to be considered by a corporation ("Acquiror") in connection with a possible acquisition of a corporation publicly traded in the U.S. or a U.K. listed company (in either case "Target") that owns insurance subsidiaries. The discussion includes acquisitions that have the support of Target's management, as well as hostile deals. Acquisitions for cash and for stock are discussed.

1. PRELIMINARY CONSIDERATIONS

a. Speed Is Less of a Factor With Insurance Targets

Parties usually structure acquisitions so that as little time as possible elapses between the announcement of a proposed acquisition and its consummation. Once a possible acquisition of a publicly traded company is announced, the transaction becomes vulnerable to competing bids, which may take the form of offers directly to Target's shareholders, seeking to sidestep approval by Target's management. In

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insurance M&A, though, speed from announcement to closing is less readily achieved because the acquisition of Target is subject to inherent and often prolonged regulatory delays averaging three to r five months. The delays inherent in acquisitions in regulated industries such as insurance place an even greater than usual emphasis on contractual protection against competing bids through a strong "no-shop" clause and a limited "fiduciary out" for Target's board, as discussed below.

b. Due Diligence

A potential Acquiror of a publicly traded insurance company should expect to conduct a substantive business and legal due diligence investigation that goes far beyond the preliminary review of publicly available disclosure documents, regulatory filings and financial statements. It is not uncommon for a Target to assemble, either on its own initiative or at the request of a potential Acquiror, a data room containing non-public information covering such core areas as: investments, actuarial analyses and reserve studies, key information technology arrangements, regulatory files, complaint logs and litigation files, reinsurance agreements, and agreements with key producers.[2] At the appropriate stage in the process, an Acquiror should also expect to have access to senior members of Target's management team, including the CEO, CFO, chief investment officer, chief information officer, chief actuary and general counsel. Legal due diligence will typically focus on identifying contingent liabilities, analyzing regulatory risks, and evaluating material contracts for change of control or merger provisions.
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While it is true that publicly traded companies are required to disclose periodically information that they consider material to investors in their securities, it is very important that Acquirors use their time in the dtata

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[2] For a discussion of insurance company due diligence issues, see Section 2 of Chapter Two.

room and in management meetings to form their own independent view as to what material issues may lurk at a Target. In most transactions, Acquiror's obligation to close the transaction will be conditioned on the absence of any material adverse change ("MAC") to Target's results of operations or financial condition from the date of the last financial statements or the date of signing the merger agreement. The MAC standard in practice is set at a high level, however, and may not provide recourse for many issues that, had they been known to Acquiror before the merger agreement was signed, would have affected valuation. It is much in the parties' interest to make a decision not to proceed with a transaction at the stage of due diligence, when the dealings between the parties remain confidential, than for a transaction to fall apart if adverse facts come to light after announcement. Section 4.b(6) of this Chapter discusses MAC clauses in more detail.

c. Confidentiality and Disclosure Issues

Preliminary merger discussions and the ensuing due diligence investigation by Acquiror should take place under a confidentiality agreement. Although neither a U.S. public company nor a U.K. listed company has a duty to disclose preliminary merger negotiations (even though a merger, if it were to be announced, might clearly be material), Target may be obliged to announce discussions with Acquiror if rumors or unusual trading occur in Target's stock, or if Target seeks to access the capital markets during the negotiation period.. Also, in the absence of a confidentiality agreement, disclosure of material information to the other party or its advisors could trigger an obligation to make a public disclosure under Regulation FD in the United States or the Disclosure Rules and Transparency Rules or Takeover Code in the U.K. Accordingly, both Acquiror and Target should use every precaution to keep information about the transaction strictly confidential through dissemination of information only on a need-to-know basis and the use of code names. The working groups should be as small as possible, because of the need for confidentiality and because of the need for efficient decision making (particularly if a bidding contest or a hostile

offer develops). Under the EU Market Abuse Directive and related Disclosure Rules in the U.K., insider lists must be maintained by public companies and made available to regulators on request. These lists contain the names of persons working for a company (whether as employees or under contract) who have access to inside information relating directly or indirectly to the company. The rules also require a company to ensure that its outside advisors maintain confidentiality lists of staff and service providers who have access to inside information relating to the company. Consumer privacy and data protection issues arising from the conduct of due diligence are discussed in Section 2 of Chapter Two.

2. STRUCTURE OF THE ACQUISITION

a. United States

(1) Steps in Unregulated Industries

It is worthwhile to compare the single-step merger approach with the alternate structure that would be common in an unregulated industry where no regulatory approval is needed other than U.S. antitrust approval.[3] Because of the need for speed, acquisitions not subject to inherent regulatory delays (including those approved by the management of Target) can be accomplished in a series of steps that put Acquiror in control of Target more quickly than can be done by a merger:

- In some cases, initial acquisition of a stock position in Target.
- Cash tender offer for Target's shares. The documents for such an offer do not require prior Securities and Exchange

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[3] *See generally*, Meredith M. Brown, Ralph C. Ferrara, Paul S. Bird, Gary W. Kubek and William D. Regner, *Takeovers: A Strategic Guide to Mergers and Acquisitions* (3d ed. Aspen Law & Business, 2010).

Commission ("SEC") approval, and such an offer does not require a shareholder vote by Target.

- Merger of Target with Acquiror (or a subsidiary of Acquiror) following the closing of the tender offer.

In a stock deal, a variation on this structure would be to substitute an exchange offer for a cash tender offer. The documents for an exchange offer likewise do not require prior SEC approval, although the offer cannot be completed until a registration statement covering Acquiror's shares is declared effective.

Under this two-step front-end tender offer/back-end merger structure, absent a need for special regulatory approval, it is possible for Acquiror to obtain a majority of Target's stock within approximately one month after beginning its tender offer for Target shares. By contrast, it would not normally be possible for Acquiror to consummate a single-step merger with Target, as the rules now are in effect, sooner than about three months after Acquiror and Target reach agreement on the terms of their transaction. This is because a merger will require the preparation of a proxy statement to be sent to Target's shareholders, containing detailed financial and narrative information about Target. Typically, it takes longer to prepare a draft of such a document than to prepare a cash tender offer, which usually contains only a brief paragraph about Target's business. Moreover, unlike a tender offer, a proxy statement must be filed with the SEC at least 10 days before being sent in final form to Target's shareholders (and, in practice, it often takes longer to clear SEC staff comments), and, if the consideration involves securities of Acquiror, the SEC must declare effective the registration statement covering those securities before the transaction can close.

Although a tender offer followed by a merger (absent a need for regulatory approval) is faster than a merger as a way to acquire control, it has a disadvantage in a regulated industry such as insurance. Specifically, a tender offer cannot be completed until necessary regulatory approvals have been obtained, meaning that the Acquiror

risks the possibility of a competing bid up until closing. A vote on a merger, however, can be taken as soon as the proxy statement can be cleared by the SEC and a shareholder meeting can be held. The vote approving a merger extinguishes the possibility of competing bids, even if regulatory approvals have not yet been obtained.

(2) Single-Step Merger in the Insurance Industry

In the insurance industry, Acquiror cannot acquire control of Target until Acquiror has obtained the prior approval of the insurance regulator in each of the jurisdictions in which Target's insurance subsidiaries are domiciled or commercially domiciled. Control is presumed, under most states' laws, at 10% of the voting stock (there are two states where the applicable threshold is 5%). Obtaining approval might take three months or more. Thus, even if Acquiror launches a tender offer as a first step in an acquisition of 100% of the common equity of Target, Acquiror cannot actually purchase more than 9.9% of the shares until it obtains this approval.[4] The need for regulatory approval takes away any advantage of speed that a first-step tender offer would otherwise afford. Moreover, it may be possible to obtain the approval of Target's shareholders for a merger before regulatory approval is obtained — and the shareholder approval typically will bind Target to the transaction agreement and end Target's ability to negotiate with competing bidders under a fiduciary exception to a "no-shop" covenant.

For these reasons, in the insurance industry, acquisitions of publicly traded insurance groups are almost always structured as single-step mergers. Prior to any public announcement, Acquiror and Target negotiate a merger agreement, which is signed and immediately announced. The parties to the merger agreement are typically Target, Acquiror and a newly formed acquisition subsidiary of Acquiror

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[4] For a discussion of insurance regulatory approval requirements on a stock purchase, see Chapter Four.

("Acquiror-Sub"). Under the terms of the agreement, Acquiror-Sub merges with Target, and the surviving company becomes a wholly owned subsidiary of Acquiror.

The merger agreement may provide that Target's shareholders receive cash, Acquiror shares (in the form of, for non-U.S. Acquirors, ADRs), a combination of cash and shares, or, in a cash-election merger, an opportunity to elect whether to receive cash or shares.

It will be necessary to review the state corporation statute of Target's state of incorporation, as well as Target's charter, to see what vote by Target shareholders is necessary to approve the merger. If Target is a Delaware corporation, the Delaware statute requires that the merger be approved by holders of a majority of Target's outstanding stock entitled to vote on the merger. Target's charter may provide for a supermajority vote. Target's charter may also include preferred stock that has a class vote on a merger. Unless Target's charter or state law provides otherwise, Acquiror is permitted to vote its own shareholdings in Target in favor of the merger. Ordinarily, under most U.S. state corporation laws, if Acquiror owns at least 90% of each class of Target's stock that would be entitled to vote on the merger, a "short-form" merger is possible — that is, the merger could be approved by Acquiror's directors, without the need for any vote by Target's shareholders. Depending upon the applicable state law, those shareholders of Target who do not vote for the merger and follow specified statutory procedures may be entitled to seek appraisal, in which case they will be entitled to the judicially appraised price of their shares (which may be more or less than the merger price). Appraisal may not be available if the merger consideration consists of shares of a publicly held company.

As approval of Target's shareholders is a condition to consummation of the merger, Target would be required to send its shareholders a proxy statement containing, among other things, a full description of Target, full financial statements of Target, and enough information to enable Target's shareholders to make an informed decision as to whether to vote for or against the merger. The proxy statement would need to

comply with the SEC's proxy rules and, if Acquiror securities comprise all or part of the consideration, the SEC's rules for prospectuses.

b. United Kingdom

(1) The City Code on Takeovers and Mergers and the Takeover Panel

In the United Kingdom, takeover offers for public companies (including public companies whose shares are not listed and also private companies if any of their securities have been publicly traded in the preceding ten years) are regulated by the City Code on Takeovers and Mergers (the "City Code"), which is a set of regulations promulgated by the Panel on Takeovers and Mergers (the "Panel").

The City Code principally applies to takeover offers for U.K., Channel Islands and Isle of Man public companies which have their registered offices in the U.K., Channel Islands or Isle of Man and who have any securities admitted to trading on a regulated market in the U.K. or on any stock exchange in the Channel Islands or the Isle of Man. The City Code may also apply to companies with registered offices elsewhere in the EEA if their securities are admitted to trading on a U.K. regulated market.

Following the implementation of the European Directive on Takeover Bids, the Panel is now designated by law as the supervisory authority to carry out certain regulatory functions in the U.K. in relation to takeovers, principally: (i) the issuance, review and amendment of the City Code, (ii) the enforcement of the City Code through the Hearings Committee of the Panel, (iii) the supervision and regulation of takeovers, consultation on the City Code, advice on interpretation of the City Code and the giving of rulings on the interpretation, application or effect of the City Code through the Panel Executive. Appeals against rulings of the Hearings Committee of the Panel are heard by the Takeover Appeal Board, an independent body whose Chairman and

Deputy Chairman will usually have held high judicial office. Although the proceedings of the Panel are open to judicial review by the courts, there have been very few occasions (and none in recent years) in which the courts have overturned Panel decisions.

As a result of the U.K.'s implementation of the European Directive on Takeover Bids, rulings of the Panel now have binding legal effect, parties to a takeover offer subject to the City Code and the jurisdiction of the Panel are not able to bring legal action against each other for alleged breaches of the City Code (thus eliminating court-based takeover tactics) and once a takeover has been implemented in accordance with the City Code it may not be rescinded.

The City Code enshrines a set of General Principles designed to set standards of behavior to ensure fair and equal treatment for all Target shareholders. The General Principles include specific "equal treatment" principles such as:

- All shareholders of the same class of Target must be treated similarly by an offeror.
- Neither an offeror, Target nor any of their respective advisers, may furnish information to some shareholders which is not made available to all shareholders.
- Shareholders must be given sufficient information and advice to enable them to reach a properly informed decision.
- At no time after a bona fide offer has been communicated to the Board of Target may the Board of Target take any action in relation to Target without the approval of Target's shareholders in general meeting if the proposed action could effectively result in any bona fide offer being frustrated or in Target's shareholders being denied an opportunity to decide on the merits of the offer.
- The Board of Target must act in the interests of Target as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid.

The General Principles are then developed into the detailed Rules of the City Code. Notwithstanding the detail of the Rules, the City Code is clear that it is to be followed in spirit as well as in letter.

The City Code sets out a detailed time frame during which takeover offers are to be conducted with specific dates by which any offer documentation is to be posted to Target shareholders and rules as to the content of such documentation; in particular, the City Code requires that for an offer to be successful, a minimum level of acceptances must have been received from Target's shareholders by the 60th day after the posting of the offer document.

There are key provisions within the City Code which enhance the importance of bidders making takeover offers only if they are prepared to be bound by them and submit themselves to the risk that a takeover offer may fail on the public stage or trigger a competing bid from a rival bidder. These include:

- Restrictions on the ability of the offeror (and those in concert with it) to deal in shares of the Target during the offer period.
- Restrictions on the ability of the offeror to withdraw or amend the terms of its offer for Target once announced.
- Restrictions on the content of announcements to be made by either the offeror or the Target during the course of the offer, and requirements as to content of any announcements, advertisements or shareholder circulars.
- In the event of a failed takeover offer for Target, a prohibition under the City Code on the offeror's making a fresh takeover offer for Target in the ensuing 12-month period.

The Panel (particularly in the light of the European Directive on Takeover Bids) has the right to report non-compliance to regulatory bodies throughout the EU, particularly to the Financial Services Authority ("FSA") in the U.K., which may consider any non-compliance by regulated entities when reviewing their standing as persons authorized by the FSA. It should also be borne in mind that if the

Target is an authorized U.K. insurer, then the offeror will be required to obtain prior approval from the FSA in order to become the holder of 10% or more of Target and the takeover offer will therefore have to include conditions as to the obtaining of all necessary regulatory consents and approvals, including from the FSA.

(2) Recommended Offer Followed by Compulsory Acquisition

The vast majority of takeover offers in the U.K., whether for insurers or other entities, are carried out through a takeover bid which is recommended to the shareholders of Target by the Board of Target. Although a recommended bid may have started off following a friendly (or hostile) approach by the offeror to the Board of Target, it is unusual in the United Kingdom (for the reasons explained in Section 5 below) for a hostile offer to be made, particularly in the case of a U.K. insurer where any takeover offer will require prior regulatory approval by the FSA and may also raise competition issues either at the U.K. national level or under European merger control regulations.

It is a fundamental rule of the City Code that absolute secrecy must be maintained until a takeover offer is publicly announced. Information must only be passed on a need-to-know basis and in confidence prior to any announcement, and the City Code requires that a takeover offer must be put forward initially to the Board of the Target. The City Code specifies the circumstances in which an announcement about the offer must be made; these include the obligation to announce immediately after a firm intention to make an offer has been communicated to the Board of Target (even if the Board is inclined to reject the approach) and also where there are untoward movements in the share price of Target, or the negotiations and exchange of information preceding any announcement has extended beyond a tight-knit group comprising the prospective offeror and Target, and their close advisers.

In a recommended takeover offer, once the offeror's proposal is accepted the takeover offer will be announced by joint announcement

made by the boards of offeror and Target, setting out the key terms and conditions of the offer, which will then be posted to shareholders of Target. Given that at this stage the key terms and conditions of the offer will have been agreed and published (particularly the detailed terms and conditions as to acceptance levels and regulatory or other conditions), there is little room for subsequent maneuver by the parties, absent the intervention of a third party competing bidder or a material change in circumstances, in which case the Panel would allow either party to seek to change terms. For this reason, it is not usual in a U.K. recommended takeover bid to find a merger agreement being negotiated or signed between the parties (as is typical in the U.S.) because the core terms are already settled and announced at the initial stage.

Following the announcement, the offeror then has 28 days to prepare the formal offer document (containing the information required by the City Code) and dispatch this to the shareholders of Target. The offer document is the mechanism under which the offeror makes a formal contractual offer to Target shareholders in a manner that they can accept by completing and returning the form of acceptance. Once the offer document has been posted, the parties may wait (nervously) to see whether a third party competing bidder chooses to intervene. Barring such intervention, however, the recommended offer must remain open for a minimum of 21 days during which time the conditions to the offer (including as to the level of acceptances) are either met or (if not met by day 21) the offer will be extended up to day 60. In the course of the offer, provided it has not limited its ability to do so by issuing a "no revision" statement, the offeror will be able to improve the terms offered to Target shareholders at any time (but not beyond day 46 if the offer is hostile) during the offer timetable.

In order for a takeover offer to be successful, Target shareholders must accept the offer up to a percentage of Target's shareholder base (as specified in the takeover offer) within 60 days of the posting of the offer document, failing which the City Code provides that the takeover offer will lapse (unless the Panel grants an extension). The level of acceptances is a key condition of the takeover offer since, although a

51% acceptance level by Target shareholders would give the offeror effective control of Target and the ability to remove its board of directors and replace them with appointees of the offeror, only if an acceptance level of 90% is reached can the offeror effect a compulsory "squeeze out" of the dissenting minority shareholders who have not accepted the takeover offer. To this end, it is usual for a takeover offer to be framed so as to include an acceptance condition of 90% but giving the offeror the right to lower that percentage during the course of the offer when the likely level of acceptances becomes clearer so as to close the offer soonest and keep out competitors. Assuming that the offeror reaches the acceptance condition and that this is set at 90% and is reached not later than day 60 (so the takeover offer is not required to lapse) the offeror will then be in a position to effect the statutory "squeeze out" of Target's remaining minority shareholders as provided by sections 974 to 991 of the Companies Act 2006.

Under the "squeeze out" provisions, a statutory mechanism is provided whereby the offeror is given the right to buy out the minority at the price offered to Target shareholders under the takeover offer; likewise, the minority shareholders who are comprised within the 10% or less of Target and did not accept the takeover offer have the right to require the successful offeror to buy them out at the price offered for shares under the takeover offer. Although the statutory framework is simple in concept and in the mechanics required for the service of statutory buy-out notices, there are pitfalls that may sometimes trap the unwary offeror. For instance, the 90% level is not set at 90% of the total shareholder base of Target but at 90% of the shareholder base "*to which the takeover offer relates*;" hence, the offeror will have effectively excluded from the 90% pool any Target shares held by the offeror or those in concert with it since these shares will not be subject to the takeover offer (and so the pool comprising the 90% of shares is made smaller). In addition, in order to catch overseas shareholders, the offeror will have to find a means to communicate the takeover offer to, and have it made available to, overseas shareholders since failure to include overseas shareholders of any particular category will again lessen the pool of shares on which the 90% test will be calculated.

In the event that a successful offeror is unable to take advantage of the compulsory "squeeze out" provisions, an alternative method of obtaining absolute ownership of Target is to effect a scheme of arrangement under part 26 of the Companies Act 2006, under which the remaining minority shareholders can, provided enough of them vote in favor and Court approval is obtained, have their shares purchased at a price which need not be the same, and on terms which need not be the same, as those applicable in the original takeover offer.

(3) Scheme of Arrangement

As mentioned above, there is a statutory procedure for the acquisition of shares in a U.K. public or private company which enables a takeover to be effected and (as described above) a process to be employed in conjunction with a takeover offer to acquire the shares of a dissenting minority.

Schemes of arrangement have grown in popularity since they require approval of holders of fewer shares to effect a takeover and also avoid a potential charge to U.K. stamp duty of 0.5% of the value of the consideration being offered.

A scheme of arrangement is a statutory procedure which allows a Target to make an arrangement or compromise with some or all of its shareholders, although the City Code will still apply. It is therefore difficult to carry out a takeover offer by way of a scheme of arrangement unless the takeover is recommended by Target's Board of Directors because the terms and implementation of the scheme will be entirely in the hands of the Board of Target. A scheme of arrangement has a number of advantages over a "usual" recommended takeover offer:

- For a scheme of arrangement to be effective, it must be approved by a special resolution of Target's shareholders by at least 75% of votes cast at a General Meeting, and must also be approved by a majority in number of those Target shareholders present and voting either in person or by proxy at a Court

Meeting, representing 75% or more in value of the Target's shares; provided it is approved by not less than this percentage level all shareholders of that class will be bound, hence delivering 100% acceptance to bidder. This contrasts with the higher threshold of 90% which bidder will have to reach under a takeover offer in order to be able to employ the Companies Act minority "squeeze out" provisions.

- In assessing the 75% threshold for a scheme of arrangement, only those shareholders who actually vote (in person or by proxy) at the relevant shareholders meeting are taken into account.
- While a recommended takeover offer can take up to eight and a half months before the bidder actually acquires 100% of Target, under a scheme of arrangement the timetable will often be shorter.
- As noted above, a scheme of arrangement (if structured correctly) should avoid the 0.5% U.K. stamp duty tax on consideration payable for Target's shares.

Other advantages in employing a scheme of arrangement include the wide discretion given to the Court to make ancillary orders, and the fact that the U.K. legal prohibitions on the giving of financial assistance by public companies or by private company subsidiaries of public companies (under sections 677 to 683 Companies Act 2006) will not apply to any assistance which is approved by the Court (thus giving wider scope for utilizing Target's assets or as to payment of costs). The very fact of there being Court hearings, however, clearly gives a forum for any vocal shareholder minority to hold out against the scheme; as well as attracting publicity for the minority's case, the Court will be obliged to consider whether the scheme treats shareholders fairly.

c. Cross-Border Acquisitions

Non-U.S. acquiring companies have typically preferred to acquire U.S. companies for cash. In general, this is because Acquiror, if not otherwise subject to the U.S. securities laws, does not wish to become subject to those laws, as would normally be the case if Acquiror were to acquire Target for shares of Acquiror. Moreover, there can be a "flow-back" problem which can depress the market for Acquiror's shares, if Target's U.S. stockholders do not wish (or are unable) to own shares of non-U.S. companies and therefore sell the Acquiror shares they receive in the merger.

In recent years, however, some non-U.S. acquirors have followed the U.S. trend by issuing common equity as the merger consideration in an acquisition by merger of a U.S. publicly traded company. In such cases, Acquiror either is already a U.S. reporting person, so that it can easily register its shares under the U.S. Securities Act of 1933 (the "Securities Act"), or has been willing to register its shares under the Securities Act and become subject to reporting requirements and possible legal exposure and reporting requirements under the U.S. securities laws. Benefits of a stock transaction include:

- It eliminates any need for cash borrowing to complete the transaction.
- The transaction can be structured as a merger that is tax-free to Target and to its shareholders who receive Acquiror's shares or ADRs.
- It makes possible low or no-premium transactions that achieve fair sharing of synergies.

(1) SEC Requirements — Stock as Consideration

In the eyes of the SEC, an acquisition of a U.S. public company for stock of Acquiror is viewed as a public offering of Acquiror stock, in that the shareholders of Target would be asked to make an investment

decision whether to exchange their investment in Target for shares of Acquiror. To complete a stock-for-stock merger, Acquiror would need to register its shares under the Securities Act. A U.S. acquiror would use Form S-4 to register the shares, while a non-U.S. acquiror would register its shares or ADRs on Form F-4, and be liable to Target's shareholders for non-disclosures or omissions in the offering materials. Until 2007, non-U.S. companies were required to present their financial statements in accordance with U.S. generally accepted accounting principles ("U.S. GAAP") or, alternatively, in accordance with their home-country accounting principles, with a reconciliation of these accounting practices to U.S. GAAP. In 2007, however, the SEC began permitting non-U.S. companies instead to present their financial statements in accordance with IFRS in the form published by the International Accounting Standards Board. Accountants and legal counsel should be consulted at an early stage of planning for an acquisition where the consideration will be paid in share, to determine what pro forma and historical financial statements of the Target would need to be included in the registration statement and the time required in preparing them.

Acquiror, once it lists its stock on a U.S. securities exchange, would be subject to reporting requirements. However, the SEC rules accommodate the unique circumstances of a non-U.S. issuer in several ways, imposing less burdensome reporting requirements than those applicable to U.S. issuers.

The content and timing of reports and notices that Acquiror would file with the SEC would differ in several respects from the reports and notices that Target or another U.S. issuer would file. Acquiror would be a "foreign private issuer" for the purposes of the reporting rules under the U.S. Securities Exchange Act of 1934 (the "Exchange Act"). If Target were a U.S. reporting company, it would file with the SEC, among other reports and notices, (i) an annual report on Form 10-K within 90 days after the end of each fiscal year, (ii) quarterly reports on Form 10-Q within 45 days after the end of each fiscal quarter, and (iii) reports on Form 8-K upon the occurrence of certain corporate events. For Targets that are "large accelerated filers" and "accelerated filers,"

the timing requirements for filing Form 10-K and Form 10-Q are reduced (to 60 and 40 days, respectively). As a foreign private issuer, pursuant to the requirements of the Exchange Act, Acquiror would be required to file with the SEC an annual report on Form 20-F within six months after the end of each fiscal year (four months for fiscal years ending on or after December 15, 2011) and furnish reports on Form 6-K upon the occurrence of significant corporate events.

As a U.S. reporting company, Target must provide to its stockholders in advance of each annual meeting of stockholders an annual report containing audited financial statements and a proxy statement that complies with the requirements of the Exchange Act. As a foreign private issuer, Acquiror would be exempt from the rules under the Exchange Act prescribing the furnishing and content of annual reports and proxy statements to its shareholders. The New York Stock Exchange and other exchanges impose various requirements for annual reports, however, and many listed foreign issuers nonetheless provide annual reports to their shareholders.

In addition, as a foreign private issuer, Acquiror would be exempt from the provisions of the Exchange Act that require officers, directors and 10% shareholders to file reports with the SEC disclosing transactions in its common shares and disgorge profits realized from any purchase and sale of its common shares within six months.

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") imposes significant disclosure requirements on public companies and their chief executive officers and chief financial officers and increases the penalties for violations of the securities and other laws. Many of the provisions of Sarbanes-Oxley are applicable to both domestic and foreign issuers, including those requiring the CEO and CFO of a company to certify financial reports. It also creates a federal crime for false certifications as to the financial condition and operations of the issuer, with penalties ranging from a $1 million fine and 10 years in prison for knowing violations to a $5 million fine and 20 years in prison for willful violations. In response to Sarbanes-Oxley, the New York Stock Exchange and NASDAQ significantly strengthened their corporate

governance requirements, particularly regarding Board and audit committee practices. Foreign issuers are allowed to follow home country practices and law rather than these requirements in many cases, however.

(2) Other SEC Considerations

In addition to the registration requirements described above for the issuance of stock as consideration in a merger or other takeover, a cross-border acquisition involving a U.S. insurance company faces other U.S. securities laws requirements, including:

- If Target is a U.S. domestic company and its shareholders will need to vote on the transaction, the transaction will need to comply with the proxy rules under Regulation 14A of the Exchange Act, including the need to provide a proxy statement (usually the same disclosure document as the registration statement) to shareholders.
- A cash tender offer or share exchange offer will need to comply with the U.S. tender offer rules under Regulation 14D (if Target's shares are registered under the Exchange Act) and Regulation 14E. These impose substantial requirements on the manner and timing of the offer, many of which are often inconsistent with requirements in other jurisdictions. For transactions where the Target is a foreign private issuer and U.S. ownership interest by U.S. holders of Target is 10% or less (called "Tier I" companies), many of these restrictions fall away. For companies with U.S. ownership of between 10-40% (called "Tier II" companies), a smaller number of restrictions are disapplied. Even if the transaction does not fit within one of these exemptions, however, it may be possible to obtain no-action relief from the SEC where the U.S. tender offer requirements are inconsistent with the legal and regulatory requirements of the home jurisdiction of Target.

3. OTHER LEGAL CONSIDERATIONS

Acquiror's counsel should review, at an early stage in Acquiror's consideration of a proposed acquisition of Target, whether there are any legal or regulatory matters that may impede the acquisition. Apart from the panoply of U.S. state insurance holding company regulations and change of control filings outside of the United States (which are discussed in detail in Chapter Four), other matters to be considered include:

a. Antitrust/Merger Control Approval

Insurance mergers and acquisitions seldom raise substantive antitrust issues unless the transaction involves specialty markets with few participants. Nonetheless, antitrust merger control laws and, in the United States, state insurance holding company acts, require Acquiror to make filings that allow government officials to review the competitive impact of the merger.

Depending on the size and nature of the acquisition, it may be necessary to report a transaction involving a U.S. business in advance to the U.S. antitrust agencies under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the "HSR Act"). The HSR Act gives the antitrust agencies time to review a proposed acquisition for anticompetitive effects prior to consummation.

Aside from ensuring compliance with HSR Act notification requirements, Acquiror and its counsel should consider whether the proposed acquisition raises any substantive antitrust problems. The transaction's effect on competition is also a criterion under state insurance holding company acts, not only in the states of domicile and commercial domicile of the operating insurance subsidiaries, but also in other states where the insurers are licensed if the post-transaction

market share in any line of business exceeds specified thresholds in those states.[5]

Acquiror and its counsel must also consider whether the proposed acquisition might be subject to mandatory merger control filing and review procedures in other jurisdictions. In Europe, for example, the transaction will be subject to review under the European Union Merger Regulation ("EU Merger Regulation") if the Acquiror and the Target have, in their most recent fiscal year for which audited accounts are available, earned enough "turnover" (for insurance companies, this comprises gross written premiums including reinsurance premiums, after deduction of taxes and parafiscal contributions or premiums) from customers in the EU to meet the "Community dimension" thresholds set out in the EU Merger Regulation.

If the parties' turnover does not meet the Community dimension thresholds, the transaction may be subject to national level merger control review in one or more of the 27 EU Member States, if the parties meet the thresholds defined in the merger control regimes of the countries in question. Note however that under the EU Merger Regulation parties to a proposed transaction that does not have a Community dimension but which does qualify for merger control review in three or more EU Member States, may file with the European Commission a request to file a Form CO "one-stop" notification with the European Commission, rather than file national level notifications in such Member States. Such request will be granted unless one of those Member States objects.

For a more detailed discussion of antitrust/merger control issues in insurance acquisitions, please refer to Chapter Five.

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5 For a discussion of "market share" statutes, see Section 2.b(2) of Chapter Four.

b. Restrictions on Government Ownership of U.S. Insurance Businesses

Some non-U.S. acquirors are entirely or, more commonly, partially state-owned. Many U.S. states prohibit the licensing of an insurer that is government controlled. In recent years, these laws have in many cases been relaxed by amendments that have changed the old, absolute prohibition into a prohibition that applies only if Acquiror is both state-owned and benefits from a subsidy.

Non-U.S. bidders have been able to proceed with acquisitions of U.S. Targets despite foreign ownership restrictions under state laws by developing mechanisms to insulate non-U.S. owners, directors and managers from operational control of the restricted business. This may be accomplished, for example, by conducting the restricted operations through a free-standing subsidiary of Target and executing a trust or proxy arrangement under which U.S. citizen directors maintain control over the subsidiary. Achieving this result, including necessary government approvals, in the time-sensitive context of a merger can be quite complicated. In other cases, where the government ownership of Acquiror is a minority position only, Acquiror may apply for a determination by the state insurance regulatory authorities that Target will not be deemed to be controlled by any non-U.S. government.

c. Other Requirements

Does Acquiror intend to acquire a U.S. bank or bank holding company or a primary dealer in U.S. government securities? If so, approval of the U.S. Federal Reserve will be required.

Even if none of these restrictions is applicable, Acquiror, if it is not a U.S. company, will need to bear in mind the need to comply with reporting requirements under the International Investment and Trade in Services Survey Act, if Acquiror acquires 10% or more of Target's voting securities.

In addition to the merger control laws discussed above, are there laws of other jurisdictions that may affect Acquiror's ability to acquire Target? Will the acquisition have to be approved by Acquiror's shareholders?

Finally, if the Target insurance company is a U.S. life insurer that has separate accounts that underlie variable life insurance policies and variable annuity contracts, an acquisition of control of the insurer may require further approvals under U.S. securities laws. For a discussion of these approvals, refer to Section 3.h of Chapter Four.

4. PROTECTING THE DEAL

As noted above, the need to obtain state insurance and other regulatory approvals for the acquisition of an insurer can lead to a lengthy period between signing and closing. As a result, Acquiror will typically insist on putting in place as many "deal protection" devices as it can achieve during negotiations to protect itself against competing bids. In many cases, Target will have a common interest with Acquiror in deterring opportunistic bids that would disrupt a fully negotiated transaction. The following section of this Chapter reviews the range of merger agreement provisions and ancillary documents that are commonly used in insurance M&A transactions to discourage disruption of a transaction by a third-party bid, and the potential limits to their application.

a. General: Deal Protection and the Duties of the Board

Before adopting any of the deal protection devices discussed below, Target's board of directors will need to consult closely with counsel as to whether, individually or in cumulative effect, these measures would result in a violation by the directors of their fiduciary duties to the company or its shareholders. Particularly for a Delaware corporation, these considerations may be affected by whether the proposed transaction is for cash or otherwise results in a sale of control, whether the company adopts these measures before or after a competing bid has emerged and whether there has been an auction or other form of market

check regarding the sale of the company. The strongest case for a full complement of protective measures can be made in a true stock-for-stock merger of equals in which no single stockholder gains a controlling stake in the combined company. In these transactions, Delaware courts have recognized that directors have broad discretion in pursuing long-term strategic objectives and, accordingly, have upheld reasonable protective devices designed to protect a transaction from third-party disruption.

Under English law, the directors of a U.K. Target must consider their duties, obligations and liabilities from a number of sources including common law, U.K. statute, the City Code and the United Kingdom Listing Authority's Listing and Disclosure and Transparency Rules. The Companies Act 2006 introduced a new statutory statement of directors' duties:

- Section 172 of the Companies Act 2006 has replaced a director's fiduciary duty to act in good faith in the best interests of the company. A director must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole. In so doing, the director must have regard to a number of factors such as the interests of employees, the long term consequences of any decision and the need to act fairly as between members of the company.
- Section 173 of the Companies Act 2006 codifies existing common law in providing that a director must exercise independent judgment.
- Section 174 of the Companies Act 2006 codifies the commonly accepted understanding of a director's duty of care, skill and diligence.
- Section 175 of the Companies Act 2006 will replace the existing fiduciary duty to avoid conflicts of interest.

The Companies Act 2006 does not contain all the necessary details on directors' duties, and common law rules and equitable principles will need to be considered in interpreting and applying the general duties.

The City Code sets out a number of requirements in relation to the responsibility of directors of both the Target and Acquiror, including as to taking responsibility for the conduct of the offer generally and in relation to particular documents as well as to ensure the equal and fair treatment of all of the Target's shareholders. Directors of a U.K. listed Target must also be aware of insider dealing offences under the Market Abuse Regime and the offences contained in the Financial Services and Markets Act 2000 concerning misleading statements and market manipulation, which can carry both criminal and financial penalties.

b. Deal Protection Devices in U.S. Acquisitions

(1) No-Shop Covenants; Fiduciary Outs

This common covenant in U.S. merger agreements typically provides that one or both parties to the merger will not, subject to certain exceptions, encourage, seek, solicit, provide information to, negotiate with or enter into a merger agreement with third-party bidders. The "no-shop" covenant consists of two elements: a "no-solicit" clause, which bars Target from soliciting competing bids, and is generally made flat, without a "fiduciary out;" and what is sometimes referred to as a "no-talk" clause, which bars Target from furnishing information to and entering into discussions with unsolicited competing bidders, which usually is made subject to a "fiduciary out." The "fiduciary out" is a proviso that permits the board to take the prohibited actions if not doing so would involve a violation of its fiduciary duties. There may also be a fiduciary out enabling Target to terminate the merger agreement to accept a competing bid. The price for this latitude is generally the requirement that Target pay a termination fee to Acquiror.

A number of transactions in recent years have included "go-shop" clauses, which allow Targets to solicit competing bids for a limited period after signing a merger agreement, often with a reduced termination fee payable by Target if it terminates the merger agreement to accept a competing bid arising during the go-shop period.

In its more restrictive formulation, the "fiduciary out" provision can be qualified by numerous conditions, including: (i) that the third-party initiative be in the form of a *bona fide* written offer that either is not subject to a financing condition or, in the opinion of the board's financial advisor, is financeable, (ii) that the third-party offer be "superior" from a financial point of view, (iii) that the third party be required to enter into confidentiality and standstill agreements before receiving any information, (iv) that the original merger partner be fully informed of all discussions with the third party and be afforded time and an opportunity to match any competing offer, and (v) that the board take such action only following receipt of advice from outside counsel. The fiduciary outs typically apply only until the shareholders of Target have approved the merger.

While some Delaware cases have upheld flat "no-solicit" provisions which prohibit a merger party from soliciting alternative transactions, Delaware courts have been critical of so-called "no-talk" provisions in no-shop clauses, which prohibit a merging party from providing information to or negotiating with potential third party bidders. The courts emphasized the duty of Target's board to act in all cases on an informed basis and suggested that bargaining away the board's ability to inform itself about a competing bid — even if only to form a basis for rejecting the bid — could constitute a breach of duty.

Under the Delaware cases, if the agreement involves a change of control which triggers the duty of the board to obtain the best price reasonably available (the so-called *Revlon*[6] duty), a flat no-talk covenant could be

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[6] *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

inconsistent with that duty. Even in a stock-for-stock merger of equals not implicating *Revlon* duties, a flat no-talk provision, at least in Delaware, may be inconsistent with the fiduciary duties of the directors of a party to a merger — in particular, the duty to be informed.

It is worth pointing out that the law of states other than Delaware may differ from Delaware law with respect to the duties of directors.

(2) Forcing a Stockholder Vote

Sometimes an Acquiror will seek a firm commitment by a Target board to submit the merger agreement to the stockholders for a vote, even if Target's board no longer recommends the transaction. The Delaware General Corporation Law expressly permits a board to submit a merger agreement—or any other matter requiring a vote—to stockholders with a negative recommendation. In cases where a Target board is required to take a proposed merger to a stockholder vote, the ability of the board adequately to inform itself as to the terms of competing bids — underscored by Delaware cases critical of "no-talk" clauses — becomes even more important.

This was made abundantly clear by the Delaware Supreme Court's decision in April 2003 in *Omnicare, Inc. v. NCS Healthcare, Inc.*[7] The court in that case struck down a fully locked-up merger agreement and essentially adopted a bright line requirement that directors of Delaware target companies must negotiate an effective "fiduciary out" in merger agreements, subject to stockholder approval. In that case, the merger agreement included a provision that the merger be submitted for stockholder approval, even if the board of Target no longer recommended the bid. At the time the merger agreement was signed, Target holders with a majority of the voting power committed to vote for the transaction. Together, these two provisions, insisted upon by the Acquiror, guaranteed that the transaction with the Acquiror would

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[7] Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003).

be approved, even if a better bid appeared before the Target stockholder meeting to vote on the merger.

The court found these arrangements were not a reasonable response to a threat, under the *Unocal*[8] proportionality test, which examines whether a board's response to a reasonably perceived threat was reasonable in relation to the threat. The court also found the lock-up to be invalid because it prevented the Target directors from exercising their continuing fiduciary duties to stockholders. According to the court, the board was "required to contract for an effective fiduciary out clause to exercise its continuing fiduciary responsibilities."

Recent Delaware case law provides one possible route to increased deal certainty, at least where there is a controlling Target stockholder and the Target's stockholders can act by written consent: the merger agreement can provide a termination right to one or both parties if the agreement is not adopted by stockholder consent within a short period – e.g., 24 hours – after the agreement is signed.[9]

(3) Break-up Fees

If the merger is not consummated because a bid is made for one of the merger partners by a third party and its board has exercised its "fiduciary out," the merger agreement in a U.S. acquisition typically provides that the other party will receive a "termination" or "break-up" fee.

The normal range is around 3% of the transaction value (often equity value but sometimes based on enterprise value. In stock-for-stock deals, the parties may agree to somewhat higher termination fees than in all-cash deals. The percentage of the transaction value tends to be

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8 Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

9 In Re OPENLANE, Inc. S'holders Litg., C.A. No. 6849-VCN (Del. Ch. Sept. 30, 2011); *see also* Optima Int'l of Miami, Inc. v. WCI Steel, Inc., C.A. No. 3833-VCL (Del. Ch. June 27, 2008) (TRANSCRIPT).

higher in smaller transactions. Note, however, that a court's willingness to approve a given termination fee will depend in part on what other payments a terminating party might be required to make (for example, expense reimbursement obligations).

There can be considerable negotiation over what triggers the obligation to pay a break-up fee. A normal trigger would be the termination of the merger agreement by either party following a decision by the board of the covenanting party to withdraw its approval of the merger agreement, to recommend an alternate transaction with a third party or to enter into an agreement for an alternate transaction with a third party. Another common trigger is the termination of the merger agreement following a negative vote by the covenanting party's stockholders if a proposal for an alternate transaction was pending at the time of the stockholder vote and an alternate transaction is consummated within some period after the vote.

(4) Stockholder Lock-up Agreements

If one party has significant management or "inside" stockholders, the other party may request that they enter into "lock-up" agreements to support the transaction. In its simplest form, the lock-up agreement would require the stockholder to agree to vote for the proposed merger and not to transfer its shares between signing and closing. From the perspective of the stockholder and of the company whose shares are thus "locked up," it is preferable if the voting agreement terminates upon termination of the merger agreement (including pursuant to the board's exercise of its fiduciary out).

The stockholder may be asked to grant the other party an option on its shares at the merger price, which option becomes exercisable in the event of a competing bid. Alternately, the stockholder may agree to pay to that party some portion of the difference between the merger price and the final price of any "topping" bid by a third party that is accepted by the board.

The merger partner who receives the benefit of a lock-up agreement may be deemed to be the beneficial owner of the stockholder's shares for the purposes of state business combination statutes. For this reason, and because Target boards need generally to understand the scope and effect of deal protection devices in the transaction, it is customary for Target's board to approve such agreements before they are entered into by the stockholder and the other party. The decision whether to approve the stockholder agreement requires the board to consider fiduciary duty issues similar to those raised by the no-shop covenant. Unless the stockholder agreement terminates upon termination of the merger agreement (including pursuant to the exercise of the board's fiduciary out), the board's approval of a stockholder agreement in a case where the stockholder controls a significant or controlling block of shares may render any fiduciary out that the board may have obtained to its no-shop covenant ineffective to permit the board to accept a superior offer. In such a case, the board's approval of the stockholder agreement will effectively have "locked up" the deal. Further, if the merger agreement contains a covenant (as discussed above) requiring the board to submit the merger proposal to a stockholder vote even if the board determines, based on a subsequent superior offer, to recommend against approval, the existence of a stockholder voting agreement covering a significant percentage of shares may limit the impact that the board's adverse recommendation will have.

In considering from how many and which stockholders Acquiror should seek to obtain stockholder voting or option agreements, the SEC's registration requirements and gun-jumping and proxy solicitation rules come into play. An Acquiror that casts its net too broadly — including non-traditional members, such as middle management, in the lock-up group — may find itself responding to SEC inquiries regarding whether it has solicited votes without filing preliminary proxy materials or has privately offered its securities in an unregistered offering.

(5) Stock Options

When mergers could be accounted for as poolings of interests, one or both of the merger partners sometimes would request that the other party grant it a stock option on up to 19.9% of that party's shares (the maximum percentage that can be issued by NYSE and NASDAQ companies without a shareholder vote) at the current market price. One reason was that the grant of the option could prevent a subsequent bidder from using pooling treatment. Since the demise of pooling accounting, however, lock-up options are rare.

(6) Other Contractual Protections

As the incidence of "deal jumping" and hostile M&A activity generally has increased in recent years, targets, bidders and merger partners have continued to find new ways to create incentives for transactions to be completed as promptly as possible, to protect against interference from third parties and to ensure that companies remain committed to an agreement once it is signed. For example, Target may require Acquiror to pay a substantial fee (sometimes called a "reverse termination fee") if the agreement is terminated because specified regulatory approvals are not obtained by a specified date. A Target pressed into a tightly locked-up merger agreement may be able to compel Acquiror to waive the material adverse change ("MAC") closing condition or narrow the definition such that Acquiror will clearly have assumed the risk of adverse changes resulting from announcement of the transaction. Merger agreements sometimes have two-way break-up fees, in which Target is entitled to a break-up fee in the event Acquiror's stockholders vote against the merger or the proposal to issue shares in the merger.

One possible threat to a deal is that Acquiror will get cold feet. Target may try to reduce this risk by insisting on a narrow MAC definition that would allow the Acquiror to walk from the deal. Whatever formulation

of the MAC clause is used, Acquirors should bear in mind the 2001 *IBP*[10] case, in which the Delaware Court of Chancery refused to let Tyson Foods, Inc. invoke a MAC clause to avoid completing a merger with IBP, Inc. The court found that, even though the MAC clause was broadly worded, Tyson had known going into the deal of the problems it claimed constituted a MAC. In applying the *IBP* holding in the more recent case of *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*,[11] the Delaware Court of Chancery noted that an Acquiror "faces a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close."[12] In the *Hexion* case, the court preserved its streak of never having found a MAC to have occurred in the context of a merger agreement, a streak that the court noted was "not a coincidence."[13] Among the lessons of these cases are the following:

- **A MAC has to be material.** Acquiror should not assume that it will be able to walk away from an acquisition because of a problem with Target's business unless the problem seriously impairs the value of the business. The standard for materiality in the context of a MAC is high.

- **Disclosure schedules are important.** Target's representations are typically limited by exceptions disclosed in a disclosure schedule. Target will want to be sure that the exceptions are broad enough, and qualify all of the relevant representations. Acquiror's goals are just the opposite.

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[10] *In re* IBP, Inc. Shareholders Litig., 789 A.2d 14 (Del. Ch. 2001).

[11] 965 A.2d 715 (Del. Ch. 2008).

[12] *Id.* at 738.

[13] *Id.*

5. HOSTILE ACQUISITIONS

Unsolicited bids and proxy contests in the insurance industry have not been numerous. They are rarely successful. However, hostile bids no longer carry with them the stigma they once had. Indeed, one of the largest-ever acquisitions in the insurance industry, AIG's 2001 acquisition of American General Corporation, began when AIG delivered (and made public) an unsolicited "bear hug" proposal to American General.

"Bear hugs" have not been uncommon in the U.K. and given that hostile takeover offers are rare in the U.K. insurance sector, a "bear hug" will usually either result in a recommended offer being forthcoming or in the offeror retiring from the scene. The recommendation of Target's board is a valuable prize for an offeror, since it will speed up the offer process, will enable the offeror to obtain in due diligence confidential information that would otherwise not be available to a hostile bidder and will, by virtue of a potentially shortened timetable and greater chance of obtaining acceptances, act to impede competing bidders.

The provisions of the City Code severely limit the effectiveness of a "bear hug," however, in that:

- Stake building in Target may be difficult to keep secret if conducted over a period of time because notification will have to be given to Target once prescribed shareholding levels are reached.
- Any information given by Target to a would-be bidder that makes a bona fide takeover approach will have to be made available also to any other bona fide prospective bidder for Target, and hence there may be a more level playing field than applies in some jurisdictions outside the U.K.
- The ability of Target to be locked into a process leading up to a bid by means of the sanction of significant cost penalties payable to the would-be bidder in the event that a

recommendation is not given is severely limited by the U.K. rules on the giving of financial assistance by Target and by the prohibition in the City Code on break fees and similar financial deal protection penalties being imposed on Target.

- Any shareholding by a would-be Acquiror or those in concert with it of 10% or more in a Target which is (or is the parent of) an authorized U.K. insurer will require prior permission from the FSA (thus limiting the would-be bidder's room for maneuver and imposing time limitations).
- A bidder that acquires shares or rights over shares in Target which would take its holding to 30% or more of the voting rights in Target may be obliged by the City Code to make a mandatory offer for the whole of Target's shares.
- Once a potential bidder has been identified in public (and under the revised City Code in operation from September 2011 there are requirements on Targets to publicly announce potential bidders from whom approaches have been received) the bidder has 28 days within which to announce a firm intention to make a bid for Target (such announcement effectively binding the bidder to follow through with the bid under the City Code) or to announce that it does not intend to make a bid, in which case it will be locked out for six months from making any announcement, or taking any steps, in either case relating to any possible offer for Target.

Hostile bids in the U.S. insurance industry have historically been rare. This reflects the difficulties faced in completing a hostile bid generally, as well as the reluctance, until the 1990s, of large companies to consider hostile bids as an acceptable acquisition strategy. Insurance companies, moreover, have significant defenses in their arsenal that are unavailable to most other companies.

Unsolicited bids (which become hostile through not being recommended by the Board of the Target) have also been rare in the U.K. insurance sector for a variety of reasons, including the expense of

mounting a hostile bid and the fact that institutional shareholder pressure on the Board of Target is likely to lead to any reasonable offer being one that Target's Board feels obliged to accept. The provisions of the City Code also serve to increase the pressure on any would-be hostile bidder when seeking to launch a hostile offer for a U.K. insurer especially given that the U.K. restrictions on Target funding bidder's abort costs may leave bidder exposed financially. Further, as discussed in Section 2.b(1) of this Chapter, the consequences of failure for the hostile bidder are significant in that the City Code will "lock out" the unsuccessful bidder from making an offer or acquiring shares in Target for a 12-month period.

a. Hostile Acquisitions in the U.S.

Regulatory and structural impediments to acquisitions of insurance companies make hostile acquisitions in this industry particularly rare. As discussed above, acquisitions of U.S. stock insurance companies face significant regulatory hurdles, including acquisition of control provisions in state insurance holding company statutes which generally require approval of the state insurance regulator in the insurance company's state of domicile before a bidder may acquire "control" of an insurer, usually deemed to happen when an acquiror holds proxies or controls 10% or more of the voting stock of the insurance company or of the holding company of the insurance company. Insurance regulators have tended to favor stability for the protection of policyholders.

The structure of non-stock insurance companies also presents a strong deterrent to an acquisition. Hostile acquisitions of mutual insurance companies have almost never been attempted, and have never been successful, because an acquisition would require a decision by the mutual's board to abandon mutuality and to implement a costly and time-consuming conversion from a mutual to a stock form.

However, the possibility of a bidder's acquiring a stock insurance company with an unsolicited bid or proxy contest, although difficult to effect, should not be written off entirely. Indeed, there have been at

least three examples of large unsolicited bids (AIG/American General, Cendant/American Bankers — although later terminated — and Nationwide/ALLIED) that led to definitive acquisition agreements. As consolidation within the industry progresses, hostile bids may accelerate as a method of acquiring control. In addition, bidders may use the threat of a hostile bid to buttress their efforts to acquire an insurance company on a negotiated basis.

Planning such acquisitions involves an intricate interplay between conventional M&A considerations and the unique features of the insurance industry.

(1) Insurance Regulatory Impediments to an Acquisition

Under the insurance holding company acts of most states, prior approval of the insurance regulator of the Target insurer's state of domicile (*i.e.,* the state where the insurer is organized) is required before any person seeks to acquire "control" of the insurer or an entity that controls the insurer (such as a public company holding an insurance company subsidiary). Prior state insurance regulatory approval is required whether control is sought by means of a tender offer, open market purchases, or in any other manner, including the purchase of either direct or indirect control. Prior approval may even be needed to conduct a proxy contest. These prior-approval requirements, in the context of an agreed transaction, are discussed in detail in Chapter Four.

State insurance regulators , on occasion, issued rulings on whether a proxy solicitation of the shareholders of a target insurance holding company would constitute an acquisition of control requiring prior approval.

In the 1990 effort of Torchmark Corporation to solicit proxies to elect five directors to the 15-member board of American General Corporation, the insurance regulators for the states of California, Hawaii, Missouri and Virginia accepted Torchmark's contention that the election of five Torchmark nominees would not shift control. However,

the Delaware, Indiana, New York, Tennessee and Texas insurance regulators ruled that the power to vote 10% or more of American General's shares constituted the acquisition of control. As discussed below, the constitutionality of the Tennessee acquisition of control law underlying the Tennessee Commissioner's ruling was the subject of a successful challenge by Torchmark.

In connection with General Electric Capital Corporation's solicitation of proxies to elect four of its nominees to the 13-member board of directors of Kemper Corporation in 1994, the Illinois Acting Director of Insurance advised, in a letter to counsel to General Electric, that he did not believe that the solicitation and exercise of the shareholders' proxies constituted an acquisition of control, in and of itself.

Acquirors that were accumulating shares on the open market or making unsolicited bids have in the past brought suit to challenge the constitutionality of state holding company acquisition-of-control laws as applied to federally regulated tender offers, on the ground that they are preempted by the Williams Act (the federal law governing tender offers) or constitute an unreasonable burden on interstate commerce. The results have been mixed.

Legal challenges to state acquisition-of-control laws were raised in connection with Hoylake Investment Limited's proposed acquisition of B.A.T Industries plc in 1989 and in Torchmark's bid for American General in 1990. Hoylake suits against nine insurance regulators, and prior litigation brought by Alleghany Corp. in connection with its proposed acquisition of 20% of the stock of The St. Paul Companies in 1988, have resulted in conflicting lower court holdings. The constitutionality of state insurer takeover laws was addressed by a higher court for the first time in connection with the Torchmark bid. The U.S. District Court for the Middle District of Tennessee in the Torchmark case granted Torchmark's request for an injunction against the Tennessee Commissioner of Insurance and held that, in ordering Torchmark to cease and desist from proxy solicitation, the Commissioner (i) was not protected by the federal McCarran-Ferguson Act because the takeover law does not regulate "the business of

insurance," (ii) was preempted by the federal Williams Act, and (iii) prevented the exercise of shareholders' rights under the Williams Act and, thus, constituted an impermissible burden on interstate commerce. American General appealed the District Court's ruling to the U.S. Court of Appeals for the Sixth Circuit, which denied a motion to stay the District Court's injunction.

(2) Other Impediments to an Acquisition

In addition to state insurance regulatory requirements, the Acquiror will consider the effect of other state law provisions regulating takeovers, including:

- Business combination statutes, such as Section 203 of the Delaware General Corporation Law, which bans mergers with a 15% or greater stockholder for three years, with certain exceptions, unless, before the threshold is crossed, the board of the Target approves either the transaction or the transaction in which the Acquiror became a 15% holder.
- Control share statutes, in which a person who acquires more than a specified percentage of stock does not receive voting rights unless the other stockholders approve the acquisition (although the Target's charter should be reviewed to determine if it has "opted out" of the applicability of such statutes).
- Statutes that permit shareholder rights plans that discriminate against certain stockholders, such as Section 14-2-624(c) of the Georgia Business Corporation Code, relied upon by the District Court in Atlanta in a July 1997 decision to uphold the continuing director provision of the shareholder rights plan Healthdyne used to resist Invacare's tender offer.[14]

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[14] *See* Invacare Corp. v. Healthdyne Techs., 968 F. Supp. 1578 (N.D. Ga. 1997).

- Statutes that permit or require directors to consider the interests of other constituencies, including employees, customers, suppliers and the communities in which facilities are located, in reviewing a proposed acquisition of the Target.

(3) Defensive Measures

Although the regulatory impediments described above are formidable, they are not a guaranteed defense to an unsolicited takeover attempt. Their principal benefit is that they deprive the Acquiror of the advantage of speed and surprise in its attempted takeover; accordingly, the Target has the ability to challenge the acquisition through the regulatory process in addition to drawing on defenses available to all targets. However, an insurance company cannot depend on a third party — the state insurance regulator — to withstand a takeover bid that can be shown to be beneficial to the target company and its policyholders and stockholders. Moreover, a regulator will be more concerned with whether a bid is prejudicial to policyholders than with the adequacy of the bid process to the Target's stockholders. An insurance group that wishes to be ready for potential unsolicited bids or proxy contests should review its situation and the defenses it would have available if the board concludes that a bid should be rejected.

(a) Structural Defenses

In addition to the regulatory defenses available to insurance companies, an insurance company or its publicly held parent will want to consider adopting one or more of the following structural defenses in its charter or by-laws in order to strengthen its defenses against an unsolicited bid:

- Maintaining a staggered board (*i.e.*, a board in which one-third of the directors are elected each year for a three-year term), so that an Acquiror cannot obtain complete control of a board in a single election; also requiring notice periods for nominating board members, restricting removal of board members except

for cause, and providing that only continuing directors can fill board vacancies.

- Restrictions on who can call special meetings of stockholders and on whether stockholders can act by written consent.
- Supermajority voting requirements for mergers.
- "Blank check preferred," which can be issued by board action without a vote of stockholders to a white squire or in connection with a poison pill.
- Supermajority requirements for stockholder amendments of by-laws.
- By-law notice requirements, so that nominations of directors or other stockholder-initiated proposals must be notified to the company a specified period of time before the stockholder meeting.

Many of these are customary in non-insurance public companies, although a publicly held insurance group will want to analyze probable stockholder reaction if they are to be proposed at a stockholder meeting. For instance, it is typically not possible to obtain stockholder approval of a staggered board provision in the case of a public company with a large base of institutional share ownership.

(b) Shareholder Rights Plans ("Poison Pills")

A shareholder rights plan is intended to discourage a bidder from acquiring more than a specified percentage of stock in a company, without the prior approval of the company's directors, by causing dilution of a large stockholder's interest in the company if it acquires more than the threshold percentage of shares (usually between 10% and 20%). Almost all rights plans have both "flip-over" and "flip-in" measures; *i.e.,* they give holders other than the Acquiror the right to buy stock of the acquiring company or of the Target at half-price if someone acquires the trigger percentage of stock. The result would be a

significant dilution of the Acquiror's economic interest in the company. Consequently, in the past decade, a rights plans has been triggered on only a single occasion; usually, a hostile bidder attempts to have the rights redeemed by the directors of the Target company before the rights would be triggered, by applying pressure on the Target through public dissemination of a "bear hug" letter, by litigation in connection with its bid, or by a proxy contest to elect new directors who would redeem the rights.

A rights plan can be adopted by the board without stockholder approval, since it is considered a dividend of the rights to stockholders. Adoption of rights plans has generally been upheld in courts since the Delaware Supreme Court's 1985 decision in *Moran v. Household International, Inc.,*[15] although there have been limits on plans (such as "dead hand" or "no hand" rights plans) viewed as limiting directors' ability to fulfill their obligations under Delaware law. The board's decision whether to adopt the plan, or whether to redeem the rights at some future time, will, in Delaware, be evaluated under the *Unocal* test.

Rights plans are common defensive measures, although strongly disliked by many institutional stockholders. As a result, it has become substantially less common in recent years for companies to maintain rights plans in the absence of a specific threat. Many precatory resolutions have been passed seeking redemption of rights plans; in some cases, they have involved companies in financial distress or in other unusual situations. Some opponents of rights plans have put forward mandatory proposals to restrict or prohibit rights plans, such as proposed by-law amendments.

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[15] 500 A.2d 1346 (Del. 1985).

(c) Board Duties in Considering a Takeover Bid

(i) Business Judgment Rule

Under Delaware law, most decisions by a board of directors will be reviewed in the context of the business judgment rule. State corporation statutes typically provide that the business of the company is to be "managed by or under the direction of the board of directors." A corollary is that a court will not substitute its judgment for the business judgment of the directors, so long as the directors act consistently with their duties of care and loyalty.

If the matter being considered relates to a takeover defense, Delaware courts require that, in addition to showing that the board had fulfilled its duties of care and loyalty to stockholders, the board establish that the plan was "reasonable in relation to the threat posed."[16] A two-step analysis is applied: the court will first determine whether the defenses are "coercive or preclusive," and, if not, the court will then determine whether they fall within a "range of reasonableness."[17] One of the key elements in assessing whether a defensive measure is preclusive is whether it prevents the ability of the Target's stockholders to act on the proposed acquisition — for example, to remove the existing directors and to replace them with directors who will seek to remove obstacles to the takeover.[18] If the adoption of the plan (or later amendment to add discriminatory provisions) is made during a contest for control, a Delaware court would apply greater scrutiny to the board's decision.[19]

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16 Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

17 Unitrin, Inc. v. American General Corp., 651 A.2d 1361 (Del. 1995).

18 *See*, *e.g.*, Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988).

19 *See*, *e.g.*, *In re* Santa Fe Pacific Corporation Shareholder Litigation, 669 A.2d 59 (Del. 1995).

(ii) "Just Say No"?

In Delaware — since *Paramount Communications, Inc. v. Time Inc.*[20] — the general view is that a Target's board of directors has the legal ability to "just say no" to an unsolicited takeover proposal in proper circumstances. In *Paramount Communications Inc. v. QVC Network Inc.*,[21] the Delaware Supreme Court noted that "where a potential sale of control by a corporation is not the consequence of a board's action, [the court] has recognized the prerogative of a board of directors to resist a third party's unsolicited proposal or offer," provided the decision of the board is "informed."[22] The circumstances of each particular case will determine what other action, if any, is required to be taken by the board as a matter of fiduciary duty. In considering the offer, the Delaware courts suggest that directors may consider the "inadequacy of the bid, the nature and timing of the offer, questions of illegality, the impact on constituencies other than shareholders, the risk of non-consummation, and the basic stockholder interests at stake, including the past actions of the bidder in other takeover contests."[23]

In *Air Products and Chemicals, Inc. v. Airgas, Inc.*[24], the Delaware Court of Chancery was asked to address the "just say no" defense in its purest form: to decide whether a Target subject to an all-cash, fully financed tender offer with a non-coercive structure could keep in place its poison pill and thus prevent fully informed stockholders from deciding for themselves whether to sell their shares in the offer. Citing Delaware

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[20] 571 A.2d 1140 (Del. 1989).

[21] 637 A.2d 34, 43 n.13 (Del. 1994)

[22] *See also* Moore Corp. v. Wallace Computer Services, Inc., 907 F. Supp. 155 (D. Del. 1995) (District Court for the District of Delaware refused to require a target company to redeem its pill).

[23] Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341-42 (Del. 1987).

[24] 16 A.3d 48 (Del. Ch. 2011).

Supreme Court precedent, the court firmly upheld the Airgas board's right to maintain the poison pill.

(d) Defensive Techniques

In addition to the regulatory and structural defenses outlined above, once the target's board has decided that it is appropriate to resist the bid, defensive techniques may include the following:

- litigation on antitrust and other issues, and public relations and regulatory activities;
- issuing shares to employees or other allies, or buying in stock to increase the proportion of shares held by management and other friendly stockholders in order to hold a blocking position under supermajority provisions;
- corporate restructuring, including recapitalization or a sale or spin-off of key assets or businesses (for example, through reinsurance); and
- buying out the Acquiror's stock holdings in the Target, although this must be reviewed to determine the applicability of the federal greenmail tax, as well as state corporation statutes (such as New York Business Corporation Law Section 513(e), which requires shareholder approval for a purchase of more than 10% of shares from a shareholder at a premium).

Under federal tax law, a person who receives "greenmail" is subject to a 50% excise tax on the gain (or other income) realized. "Greenmail" is any amount a corporation (or any person acting in concert with such corporation, such as a white knight) pays to acquire stock in such corporation if (i) the stockholder held the stock for less than two years before agreeing to the transfer, (ii) at some time during the two years prior to the acquisition the stockholder made or threatened to make a public tender offer for the stock of the corporation and (iii) the

acquisition is pursuant to an offer that was not made on the same terms to all stockholders.[25]

(e) Entering into a Transaction with a White Knight

Under *Paramount*, a strategic merger with a white knight, in which the consideration is stock rather than cash, does not trigger a duty to seek the best price reasonably available, if the transaction does not involve a change of control — *i.e.,* if, after the transaction, control remains in a fluid aggregation of public stockholders. A merger involving the Target with a white knight, however, may require a vote of the Target's stockholders (if the Target is itself a party to the merger or the Target is issuing shares representing 20% or more of its voting power, requiring stockholder approval under New York Stock Exchange and NASDAQ rules). If so, the feasibility of obtaining the requisite vote will need to be assessed, for instance if the hostile bidder is offering a premium while the strategic merger does not.

If the Target decides to seek a sale to an alternate suitor (or the hostile bidder itself) in a transaction resulting in a change of control of the Target, it must, under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[26] *Paramount Communications Inc. v. QVC Network Inc.*[27] and other Delaware court decisions, seek to obtain the best price reasonably available to stockholders. While one way to do this would be to run an auction for the company, Delaware law recognizes that there is "no single blueprint" that directors must follow.[28] Acceptable alternatives might include a less formal "market check" or entering into an agreement with

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[25] U.S. Internal Revenue Code of 1986 (as amended) § 280G.

[26] 506 A.2d 173 (Del. 1986).

[27] 637 A.2d 34 (Del. 1993).

[28] *Id.* at 44, *citing* Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1286-87 (Del. 1989).

a white knight that includes a "go-shop" provision or that otherwise does not unreasonably deter future bids.

(f) Mutual Insurance Companies

Many insurance companies are not stock companies, and thus do not share the vulnerabilities of public companies to a hostile bid. Most non-stock insurance companies are mutual insurance companies, with voting rights held by policyholders of the insurer. An acquisition of a mutual insurance company by a stock company would require a demutualization of the target — *i.e.,* the conversion of the mutual insurance company to stock form. Demutualization requires adoption of a plan by the mutual insurer's board of directors. A demutualization is a lengthy process, involving several months (and often a year or two) of discussions with the domestic state insurance regulator, a public hearing and a vote of policyholders, before approval is obtained from policyholders and the regulator. Furthermore, some state demutualization laws, and the plans of demutualization approved by insurance commissioners, have contained prohibitions against anyone's acquiring beneficial ownership of 5% or more of the voting stock of the demutualized insurer either before or for five years after the demutualization, except with the prior approval of the insurance commissioner of its state of domicile. Such a provision gives a demutualized company five years to get established and running as a stock company before it becomes exposed to takeovers in the same manner as any other stock company. In December 1995, as Guarantee Mutual Life Insurance Company was nearing completion of its demutualization, American Mutual Life Insurance Company (since renamed AmerUs Life Insurance Company and later acquired by Aviva) attempted to acquire control of Guarantee by proposing to acquire stock in the demutualization. The attempt was resisted by Guarantee and was ultimately withdrawn.

b. Hostile Acquisitions in the U.K.

As indicated above, it is unusual in the U.K. for a hostile offer to be made, particularly in the case of a Target engaged in the insurance sector as any takeover offer will require prior approval by the FSA and may also raise either U.K. or EU competition issues. Even from a due diligence perspective a potential Acquiror would have to rely on publicly available information on the Target which will necessarily have limitations.

(1) The City Code on Takeovers and Mergers

Perhaps most importantly, however, the provisions of the City Code on Takeovers and Mergers issued by the Takeover Panel may serve to restrict an Acquiror's ability to build a stake in the Target prior to announcing an offer and indeed during the course of an offer by imposing certain disclosure obligations in addition to the disclosure requirements of chapter 5 of the U.K. Listing Authority's Disclosure and Transparency Rules as regards any interest of 3% or more (which applies irrespective of whether any offer period has begun).

The City Code also heightens the risk for would-be bidders in that their interest in Target or any approach made by them to Target may be required to be made public under the City Code and may force the would-be bidder into a 28 day period in which to either commit to making a bid or have to withdraw for six months.

The City Code may also affect the terms of an eventual offer regarding the minimum level and form of consideration. If purchases are made during the three months prior to the offer period, or during any period between the commencement of the offer period and the announcement of a firm intention to make an offer by the Acquiror, then the offer must not be on less favorable terms. Speculation in the market prior to any announcement may in fact push up the price which in itself may further prevent stakebuilding. Where 10% or more of any class of Target's voting shares have been acquired for cash during the offer

period and the preceding 12 months, or any shares of any class of the Target have been acquired for cash during the offer period, the offer for that class of shares must be in cash at not less than the highest price paid.

Any attempt to build a stake in a Target subject to the City Code will be subject to a ceiling of 30% of the voting rights, since once an Acquiror holds that amount of Target's shares it is obliged under Rule 9 of the City Code to make a mandatory offer in cash at no less than the highest price paid by the Acquiror over the previous 12 months. Moreover, the City Code recognize the concept of persons acting in concert in applying such thresholds and so Acquirors and their advisers must consider who might fall within the definitions at any given time.

(2) Target's Defense

Any Target's effective defense of a hostile bid will be aided by its own internal housekeeping to ensure that it can be alerted to the existence of a potential predator at the earliest possible opportunity and be able to respond quickly and communicate effectively with its major shareholders. This preparation should include reminding the directors of their duties under the City Code and also their fiduciary duties, described above. Target's advisers usually prepare a memorandum to the Board covering these and other matters, such as the appointment of an independent committee of directors pursuant to the City Code. It may also be good practice to have prepared in advance a draft holding press announcement in response should an approach materialize. This is particularly important given the application of the Disclosure Rules section of the FSA Handbook.

Monitoring Target's own share register on a regular basis may be no guarantee of an early warning, given that purchases in the market are restricted and therefore not as common for the reasons set out above, although instructing Target's registrars to watch volumes can be of assistance. Target can also issue notices under section 793 of the Companies Act 2006 to establish the identity of underlying owners of

any new, or existing, holdings held in nominee names. This tool has become increasingly useful for a Target which suspects a hostile bid, as the use of nominee accounts has grown in recent years. Registrars can also be instructed to alert the Target if there is a request for a copy of its shareholder register.

(3) Restrictions on Frustrating Action

As noted above, U.S.-style poison pills are rarely adopted in the U.K. The City Code has rules against frustrating action, and any alteration to Target's share rights will require shareholder approval. Traditionally, U.K. institutional shareholders have not been supportive of such structures. The general principle of the City Code provisions is that at no time after a bona fide offer has been communicated to Target's Board, or after the Board has reasons to believe that an offer may be imminent, may action be taken by the Board in relation to the affairs of the company, without the approval of shareholders, which could effectively result in any bona fide offer being frustrated or in shareholders being denied an opportunity to decide on its merits. This is widely defined to include, for example, business or asset disposals, contract renegotiations not in the ordinary course, share issues or the payment of a dividend outside the normal timetable.

CHAPTER TWO — PRIVATE ACQUISITION OF AN INSURANCE BUSINESS

NICHOLAS F. POTTER, JOHN M. VASILY, JEREMY HILL, MICHAEL D. DEVINS AND JOHN DEMBECK[1]

1. TAILORING THE STRUCTURE TO MEET THE PARTIES' GOALS

In structuring a private insurance merger or acquisition, the parties have more freedom than exists in a public acquisition to allow their respective commercial objectives to dictate the form of the transaction. However, understanding and properly planning for the regulatory aspects of the transaction – what approvals will be required, what substantive standards will be applied in the regulatory approval process, what the likely timing will be – is a critical factor for the parties to consider and may also influence their choice of structure. Among other things, obtaining regulatory approval typically takes time (requiring negotiations over allocation of risk between signing and closing), a buyer is not guaranteed to be approved (especially in non-U.S. deals, thereby raising execution risk to a seller) and conditions could be placed upon such

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approval by the regulator (raising issues of to what extent the buyer must accept such conditions).

a. Acquire an Insurer With Its Entire Business

A seller will often wish to dispose of the insurer's entire business. This is common where the insurer's in-force business is not core to the seller's future plans and has associated employees, contractual relationships, etc., which are not used in any other aspect of the seller's business. Such a disposal will commonly take the form of a sale and purchase of the stock of the insurer or its holding company. As in most share sales, with the stock of the insurance company comes all its assets and liabilities, both contractual and extra-contractual. An acquiror will therefore seek disclosure of all actual or potential liabilities of the Target as well as protection against undisclosed or unbargained-for liabilities through representations, warranties and indemnities. Unlike a public acquisition, such protections typically survive the closing of the transaction and are thus often heavily negotiated. Innovative structures that are specific to the insurance industry, such as stop loss reinsurance, may also be used to provide an acquiror with protection against insurance policy-related liabilities. Insurance company stock purchase agreements are discussed in Section 3 of this Chapter.

b. Acquire an Insurer But Only Part of Its Business

An acquiror may wish to acquire the insurer but only part of its business. For example, if the Target insurer writes auto insurance, homeowners insurance and commercial fire and liability insurance, then the acquiror may want to keep some or all of one line of business and exclude some or all of another. If all of the business has been written by the same insurer or by members of the same insurance holding company group, the business that the acquiror wants to keep may be separated from the business that the acquiror does not want by extracting from the Target either the assets intended to be sold or the assets intended to

be retained.. Eliminating business from the Target's operations, so that the Target's stock may be acquired, may be complicated: in some U.S. states, for example, laws may obligate the insurer to renew certain types of policies or impose regulatory requirements (such as lengthy notice periods) to protect consumers against abrupt withdrawals from writing new business and arbitrary non-renewal of policies. Across Europe, regulatory approval will often be required for any bulk transfer of insurance policies from one insurer to another. If the Target has to effect such a transfer in favor of, *e.g.*, an affiliate pre-closing, it may significantly delay the acquisition.

An alternative is for the acquiror to buy the Target's stock, but to eliminate the Target's economic interest in the unwanted business by reinsuring it, either with an affiliate of the seller or with an unaffiliated third party reinsurer. The reinsurance typically takes the form of 100% quota share or excess of loss coverage, often coupled with some form of assurance against adverse development of reserves at closing.[2] The ability to reinsure the unwanted business out of the Target permits significant flexibility in structuring privately negotiated insurance acquisitions. However, acquiring the Target's stock still carries with it the risk of assuming undisclosed or unwanted liabilities. In addition, the reinsurance arrangement will expose the acquiror to the reinsurer's credit risk. However, there are various means of protecting against the credit risk inherent in any reinsurance agreement, including collateralizing the reinsurer's obligations through a funds withheld arrangement, a reinsurance trust or a letter of credit.

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[2] A quota share reinsurance agreement cedes a fixed percentage of each risk covered. A 100% quota share reinsurance agreement, therefore, would transfer financial responsibility for 100% of each covered risk to the reinsurer. In contrast, an excess of loss reinsurance agreement cedes only losses that exceed an agreed threshold.

c. Acquire a Block of Insurance Business

An acquiror may want to acquire a group of insurance policies (referred to as a "block" or "portfolio" of business) without the corporate entity in which the block of business resides. For example, if an acquiror is interested only in purchasing a particular product or line of insurance from an insurer that has a diverse mix of business, or that sells the particular product or line using multiple legal entities, this transaction structure may be the most practical option. It may also be the case that the acquiror, for strategic reasons, is keen to avoid assuming liabilities that would otherwise travel with the Target's stock. In any event, this simplified transaction structure permits a strategic reallocation of a specific block of insurance liabilities and assets from the Target to the acquiror without the complications and risks inherent in a stock purchase.

Although the block of business may be acquired with some or all of the people and assets currently used by the Target in running that business, this type of transaction is particularly favored where the acquiror wants to acquire a specific block of insurance business but needs neither the Target itself nor its employees or other assets, because the acquiror already has its own properly licensed and adequately capitalized insurer and its own administrative staff and platform to service the acquired business.

Even where no employees or assets are to be acquired, these transactions tend to include some ongoing services to be provided by the Target to the acquiror in respect of the transferred block of business. For example, the Target may agree to license the use of its computer software to the acquiror until the acquiror is able to integrate the business into its own network. Asset purchase agreements, of which block or portfolio acquisitions are one form, are discussed in Section 4 of this Chapter.

d. Acquire Renewal Rights

As an alternative to (or in combination with) a block of business acquisition, the parties may opt for a "renewal rights" transaction. This type of transaction requires the seller to provide the acquiror with an exclusive right to seek renewal of policies originally issued by the Target or one of its affiliates.

In jurisdictions where the transfer of liabilities under an in-force block of business would be subject to a lengthy consultation and/or regulatory approvals process, a "pure" renewal rights transaction may provide a useful and speedier alternative, as the existing in-force block of business is retained by the seller. It may be combined with 100% reinsurance (usually provided by the acquiror or an affiliate) of the in-force business, so as to pass the economic interest in that business to the acquiror. It may also be combined with a transitional arrangement, whereby the Target agrees to "front" the renewal of new policies for the acquiror for some period of time while the acquiror is not yet authorized to conduct the acquired block of business, or does not have approved policy forms (and, where applicable, rates) in place.

It is not uncommon for renewal rights to be acquired in combination with a block of business: transfer of a block of business may take some time to achieve, whereas the acquiror can start renewing the policies on a rolling basis as soon as the transaction has closed.

e. Acquire a "Clean Shell"

A clean shell is an insurer that has licenses to do business in some or all U.S. states (or in foreign countries), but that is not writing new business and has little or no in-force business. There is an active secondary market in the U.S. for clean shells, and those that are licensed on a nationwide basis command a significant purchase price, particularly if licensed to write insurance in many, if not all states, or in all of the key states. The purchase price generally represents the value of the licenses as well as the minimum surplus that is retained by the insurer in order to

remain in good standing and not have its licenses revoked. If the Target insurer has any residual insurance liabilities on its books, they are typically ceded in full to and assumed by a creditworthy reinsurer prior to sale, often to an insurer affiliate of the seller.

If, in lieu of acquiring a clean shell, an acquiror must organize and license a new insurer, it must first incorporate and be licensed in a state of domicile, and then become licensed in every other state in which it seeks to do business. Depending on the states, this process may require from three to nine months (and sometimes longer). Some states will not license a foreign insurer unless it has been in business in its state of domicile for at least three years, except for a newly-formed subsidiary of an already licensed insurer (so-called "seasoning requirements"). For these (and other) reasons, a clean shell can be very attractive, since the only consent required will likely be the Target's domicile (or in some cases also commercial domiciles or the domicile of an affiliate insurer providing reinsurance for the Target's pre-closing insurance liabilities).

The situation is somewhat different in Europe. There is no comparable market in clean shell insurers across Europe: indeed, the "passport" provisions of the key European Community ("EC") Insurance Directives generally make it unnecessary for the acquiring insurer to have an authorization to carry out insurance business in each and every European Union ("EU") country in which the business to be acquired has been conducted, so long as it has it in one.

2. KEY DUE DILIGENCE ISSUES

With the increasing emphasis on enterprise risk management, insurance acquisitions tend to involve significant due diligence by the acquiror focused, among other things, on assessing contingent liabilities and regulatory risks, and testing and verifying the seller's estimates of future cash flows. In addition to due diligence common to many businesses, insurance acquisitions require highly technical yet critically important specialized due diligence items, as described below. This due diligence is typically performed by a combination of the acquiror's lawyers,

accountants, actuaries and financial advisers, and backstopped by carefully drafted and extensively negotiated representations and warranties.

Some information about the Target may be publicly available. Insurance holding company filings made by U.S. insurers will disclose, among other things, (i) agreements between controlled insurers and their parents, affiliates and subsidiaries such as reinsurance agreements, management agreements, investment agreements and tax and other expense sharing agreements, (ii) purchases, sales and guarantees between controlled insurers and their parents, affiliates and subsidiaries, and (iii) shareholder dividend notices to state insurance regulators and filings for approval for payment of "extraordinary dividends" by insurers to their shareholders. In the U.K., copies of regulatory returns, as well as annual accounts and other corporate material, may be obtained from the Target's publicly available corporate records (many of which are available online). However, most information which a prudent acquiror is likely to require will have to be supplied by the seller.[3]

In making due diligence material available, both seller and acquiror need to be mindful of the potential disadvantages to them in sharing what will often be commercially sensitive information and of any antitrust implications arising from the sharing of such information. The seller is likely to require the acquiror to enter into a suitable non-disclosure agreement, controlling use and circulation of due diligence material, before the process commences.

In addition to the issues commonly faced by any acquiror in an M&A transaction, such as consideration of employment agreements and pension liabilities, information technology, material contractual arrangements and the like, the insurance industry poses some particular

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[3] In many Asian countries, certain books and records, such as the regulators' periodic audit reports, are considered as owned by the regulator itself and cannot be shared with potential acquirors, adding to the challenges of completing a thorough due diligence review.

challenges in terms of the areas which are likely to feature prominently in the acquiror's due diligence exercise and the manner in which that exercise is conducted. The following subsections consider some of these in more detail.

a. Consumer Privacy and Data Protection Issues Arising From the Conduct of Due Diligence

Insurance businesses often contain a great deal of information about individuals in their capacity as policyholders and the parties need to pay close attention to applicable consumer privacy and data protection requirements when conducting their due diligence. The ability of the seller to share non-public personal information about individual policyholders is restricted in the U.S. A similar environment (though applying to the "personal data" of individuals generally) prevails in Europe, Asia and South America: that data must be processed fairly and lawfully, which generally means disclosure only where the individuals concerned have consented to it.

In the U.S., NAIC model consumer privacy regulations contain an exemption from the notice and opt-out provisions which would otherwise apply, where the sharing is "in connection with a proposed or actual sale, merger, transfer or exchange of all or a portion of the business or operating unit" and where disclosure concerns solely consumers of the business or unit. However, a large number of states do deviate from these regulations and the parties will want to ensure that no individual policyholder information is supplied as part of the due diligence process in breach of applicable state regulations.

In the U.K., any supply to the acquiror of "personal data" relating to policyholders, employees and other individuals connected in some way with the Target or its business by the Target and its receipt by the acquiror will each constitute a separate "processing" of that data for the purposes of U.K. data protection legislation. "Personal data" is defined as any information relating to an identified or identifiable living person. In practice, any reference to a person's name, which is associated with

some other personal information about them, such as an address or telephone number, will fall within the definition. Many countries in Asia have similar rules, in many cases patterned after the European rules.

The legislation requires data to be processed fairly and lawfully, which means (*inter alia*) that the subjects of the personal data must be given what is called "fair processing information" before the processing takes place. In practice, this means that individuals must be told the identity of the person controlling the data (usually the insurer) and the purpose for which the data will be processed. Since few U.K. insurers are likely to have told their policyholders in advance that their data may be "processed" for the purposes of a potential sale, the supply of personal data via due diligence has the potential to render both seller and acquiror in breach of data protection legislation unless they notify the individual about the proposed disclosure before it is made.

This rarely happens in practice and the usual approach is to anonymize data in some way (so that individuals cannot be identified from it). Where some disclosure of personal data is unavoidable, the existence of the non-disclosure agreement will be important; it must restrain use and disclosure of personal data by or on behalf of the acquiror so as to minimize the potential consequences of non-compliance with the legislation.

As well as providing "fair processing information," the legislation requires the act of processing per se to be justified under one or another of its conditions. One condition is that the consent of the individual policyholders has been obtained. In practice, this condition is usually of little practical use in a due diligence situation and the parties will try to rely instead on the "legitimate interest" condition, if it is not possible to anonymize the data. This allows processing of personal data where it is in the legitimate interests of the seller and the acquiror and is not prejudicial to the legitimate interests of the individuals. "Legitimate interest" is usually viewed as encompassing a proposed sale of the company or business. However, explicit consent from the individual for disclosure will be required where the personal data consist of "sensitive personal data," a more protected category of data that includes

information relating, among other things, to an individual's racial or ethnic origin or health.

b. Financial Due Diligence

(1) Reserves

Insurance reserves are an accounting concept. When an insurer writes any kind of insurance policy, it must set up, as a liability on its balance sheet, a reserve with respect to that policy. This reserve is meant to be a provision to reflect the obligation that the insurer must satisfy at some future date.

The manner of calculation and presentation of that reserve will depend, *inter alia*, upon the purposes for which it is being effected. Reserves which are shown in an insurer's annual report to shareholders and accounts have in the past usually been determined in accordance with normal accounting principles such as GAAP or IFRS, subject to certain modifications appropriate to insurers. The purpose of such accounting standards is to present fairly the results of the operations of a company, that is, to match the company's expenses with revenues in such a way that the revenues recorded for a particular period have expenses charged against them that appropriately relate to that period: net earnings should fairly present the operations of the company.

However, financial statements or returns filed with regulators have a different purpose — that of measuring solvency. Reserves prepared in accordance with U.S. statutory accounting principles (SAP) tend to be calculated on a more conservative basis than they are under normal accounting standards: the focus is much more on the liability side of the balance sheet, as if measuring whether, if the insurer were to be liquidated the next day, its assets would be sufficient to satisfy its liabilities.

Issues related to reserves are a source of difficult negotiations in insurance M&A transactions, particularly where actuarial studies

conducted on behalf of the acquiror suggest that the Target is or may be under-reserved. Any assessment of appropriate reserves invariably involves a degree of subjectivity as to the likely frequency of occurrence, severity of insured risks and other assumptions that figure into the actuarial analysis. Property/casualty business may be quite volatile in nature and this makes reserving for it a complex process. Long-tail (for example environmental or asbestos-related) or long term (life and related risks) business presents its own difficulties arising from the extended period of the insurer's liabilities, the element of asset risk introduced into the calculus, and the need to make assumptions far into the future.

If inadequacy of reserves is an issue, the acquiror may seek to have the seller stand behind the reserves (*e.g.*, through injecting more capital, a guarantee of reserves or an adverse development reinsurance agreement, discussed in Section 3.a(3) of this Chapter). In other situations, due diligence may not suggest any specific problem with the Target's reserves. In these cases the seller will typically resist strongly any requirement to guarantee or otherwise stand behind a possible reserve strengthening by the acquiror following the acquisition. Nevertheless, the acquiror may push to have the sellers represent and warrant as to particular factual matters that were relevant in making the reserve calculations.

(2) Investment Portfolios

Insurers established in the U.S. and the EU are subject to varying degrees of regulatory control as to the types of assets in which they may invest and the amount which they may invest in particular assets. However, a combination of regulation and commercial prudence will generally dictate that:

- assets have an appropriate degree of safety, yield and marketability, given the type and extent of the insurer's liabilities; and

- investments are diversified so as to avoid excessive exposure to any one category of investment or counterparty.

The acquiror will undoubtedly wish to make its own assessment of the Target's investment portfolio with these factors in mind, not least because of the implications for capital adequacy requirements of the Target's investment strategy.

The turbulence on evidence in investment markets in recent years illustrates the importance of a careful examination of a Target's investment portfolios. High profile bankruptcies and governmental bail-outs amply demonstrate the need to ensure that the Target's investment portfolios avoid excessive exposure to one company or sector. Acquirors are also well advised to scrutinize the Target's mix of asset classes in light of the severe stresses that have recently affected the markets for mortgage-backed investments and structured securities. The quality of investment portfolios is likely to be particularly important in the evaluation of a life insurance business, since life insurers commonly invest in a significant portfolio of long duration assets in order to support long-term liabilities to policyholders.

With the advent of the financial crisis in the U.S. real estate markets and the financial difficulties of the American International Group and other major financial institutions in 2008, state insurance regulators began paying special attention to insurer investment practices, including investments with significant real estate exposure and the use by insurers of derivatives and securities lending. These additional areas may require attention during the due diligence process.

(3) Existence of Guaranteed Benefits

In the life sector, many insurance companies have issued policies and annuities offering a minimum guaranteed benefit. In today's market, the returns on the investment assets underlying these policies may not be able to support the minimum guaranteed benefit, resulting in a negative spread on these policies and annuities. These guaranteed benefits have

had a profound effect on the U.K. life sector, in particular, and have prompted the closure of some funds (notably the U.K.'s Equitable Life) to new business. Japanese life insurance companies went through a similar phase of negative spread policies, and such issues still exist throughout Asia. Acquirors should carefully scrutinize any products offered by the Target with these kinds of features and the investments against which they are matched to determine their potential effects on the economics of a transaction.

A popular product in the U.S. is a variable annuity that offers guaranteed benefits, including a guaranteed minimum income benefit, a guaranteed lifetime withdrawal benefit and a guaranteed minimum accumulation benefit. Since a variable annuity may have a substantial portion of its assets allocated to equity investments, these guarantees assume that the promised benefits will be available even if the separate account assets supporting the variable annuity are reduced to zero. Some life insurers hedge this guarantee risk using derivatives. Since these guarantees may be for the life of the annuity contract holder, special attention may be needed to review any existing hedging program and plans for future hedging. This need was highlighted following the extraordinary drop in worldwide stock prices in 2008 and early 2009.

c. Reinsurance

(1) Intra Group

The Target may have ceded at least some reinsurance to its affiliates. This may have occurred because (for example) the affiliate was intended to bear the economic risk/reward of the relevant insurance business but lacked the necessary licenses or authorization to write it on a direct basis. The converse may be true and the Target may reinsure all or part of an affiliate's business. Historically, some multinational insurance companies have used reinsurance as an efficient way to repatriate funds or secure tax benefits.

U.S. property/casualty insurance groups with multiple insurer subsidiaries often enter into a reinsurance pooling agreement under which group insurer members cede 100% of their risks to a single affiliated pool leader and the pool leader retrocedes a portion of the entire pooled risks to each group insurer member, retaining a portion for itself. This has the effect of having the pooled capital of the participating insurers support the pooled insurance liabilities.

Whatever the position, the parties will need to consider at an early stage what is to happen to these intra-group reinsurances. If the block of business to which the reinsurance relates needs to be transferred to or from the Target so as to extinguish the need for the intra-group reinsurance going forward, the time required to achieve this (and to obtain any necessary regulatory approvals) will need to be factored into the overall transaction structure. If the Target is a party to a reinsurance pooling agreement, consideration might be given to whether the Target should be removed from the pool for new and in-force business prior to the acquisition. If so, then this may require commutation of in-force business to remove the Target from the pool and the seller reconstituting the pool using the remaining group members.

(2) Third Party Reinsurers

Reinsurance may also present a concern where the Target has a significant amount of third party ceded reinsurance. The purpose of reinsuring with unaffiliated reinsurers is to spread risk, as well as to achieve other business and financial goals. If the reinsurers are not financially strong, or there have been contractual disputes or litigation between the Target and its reinsurers, or the relevant reinsurance agreements contain provisions allowing the reinsurers to terminate the agreements upon a "change of control" of the Target, then the acquiror may be forced to incur additional expense and uncertainty in replacing the Target's existing reinsurance agreements. Conversely, the acquiror may also determine that the terms of the Target's existing reinsurance are sub-optimal. In such a case, the acquiror may seek to determine

whether the existing reinsurance can be terminated, commuted (in the case of property/casualty reinsurance), recaptured (in the case of life reinsurance) or replaced.

It is also important to evaluate whether any net retention provisions in existing third-party reinsurance agreements may limit the seller's ability to transfer 100% of its retained business (or required the third party reinsurers consent to the 100% reinsurance).

(3) Finite Risk Reinsurance

An acquiror may also be concerned to ascertain whether the Target has provided or benefitted from any finite risk reinsurance, as certain types of finite risk reinsurance have become subject to a good deal of attention from prosecutors and regulators. These products have been criticized as being in reality financing and/or inappropriate loss smoothing arrangements, rather than reinsurance.

It is not possible to specify exactly which types of finite risk reinsurance excite most scrutiny; however, the key features of some of the arrangements that have caused most concern are:

- limited (or no) uncertainty as to whether a loss will occur (by way of example, a contract which will pay out where a business's loss ratio exceeds 50% over a given period, when historically the loss ratio has always exceeded 70%, might fall into this category). In some cases, the loss covered by the arrangement may already have occurred;
- the contract requires several substantial payments to be made to the reinsurer, over a period of years, which continue even after a claim has been made, instead of a one-off reinsurance premium payable at the outset (the former arrangement is more akin to repayment of financing provided by the reinsurer, which has the effect of smoothing the reinsured's losses over several financial years, than a traditional reinsurance premium); and/or

- the contract contains a mechanism whereby the reinsured is either refunded some of its premiums where losses are less than expected or is required to top up payments where losses exceed expectation. If this leaves the reinsurer with little or no risk in return for a payment from the reinsured, it has more in common with a fee than a reinsurance premium.

Leaving aside the adverse publicity which some finite risk products have generated, there are several reasons why a potential acquiror might be concerned at the existence of any of these products in the Target's books:

- If the Target has reinsurance contracts, under which it is the cedant, with any of these characteristics, its financial statements or accounts may have been distorted as a result of these arrangements. Finite risk reinsurance has sometimes been alleged to have been purchased by entities under financial pressure, who are keen to smooth earnings and, in particular, improve them for a particular financial period.
- Depending on the circumstances in which the product was purchased, it is possible that some element of fraud may have been involved.

It is not uncommon for finite risk reinsurance transactions to have been documented in side letters or unwritten side agreements to a principal contract. Many regulators, notably the U.K.'s Financial Services Authority ("FSA"), have criticized this practice and, for this reason, if an acquiror does have reason to believe that any side agreements may exist, copies or details of these should be requested as part of due diligence or a warranty obtained to confirm that there are none. Furthermore, the use of undisclosed side letters may violate a condition of U.S. financial statement credit for reinsurance, namely, the inclusion of an "entire contracts" clause in the reinsurance agreement. U.S. concerns about property/casualty finite reinsurance led to enhanced disclosure in the interrogatories to the property/casualty statutory annual financial statement and the execution of a special attestation of the chief

executive officer and chief financial officer of the insurer regarding reinsurance agreements.

(4) Terrorism Risk Insurance Act Issues

Potential acquirors of a U.S. insurer will need to consider the impact of the U.S. Terrorism Risk Insurance Act of 2002 ("TRIA"). Signed into law on November 26, 2002, TRIA established a temporary federal program (the "Program") of shared public and private compensation for insured commercial property/casualty losses resulting from an act of terrorism, as defined by TRIA. The Program is administered by the Secretary of the Treasury (the "Secretary"). Originally set to expire on December 31, 2005, the Program was extended for two years through December 31, 2007 but with changes that require the insurance industry to carry a greater share of losses resulting from covered "acts of terrorism." The Program was further extended for seven additional years through December 31, 2014. TRIA originally covered only foreign terrorism but was amended in 2007 to include domestic terrorism.

Under TRIA, the Federal government pays 90% (85% for years 2007 2014) of insured losses in excess of an insurer's deductible, while the insurer pays 10% (15% for years 2007-2014). An insurer's deductible is based on a percentage of direct earned premiums for the previous calendar year. Insurers' deductibles were 7% in 2003, increasing to 10% in 2004, 15% in 2005, 17.5% in 2006 and 20% in years 2007-2014. Insurers may reinsure their insurer deductibles and co-shares. Losses covered by the Program are capped at $100 billion per year. Above this amount, Congress is to determine the procedures for and the source of any payments.

Under TRIA, all "insurers" receiving "direct earned premiums" for any type of commercial "property and casualty insurance" coverage must participate in the Program.

An acquiror will need to investigate whether the Target has complied with TRIA sufficiently to receive the reinsurance cover provided for

under TRIA. Acquirors will also want to consider what protections to put in place when and if the protections offered by TRIA expire. TRIA expires December 31, 2014.

d. Reach of Target's Business

Another key due diligence concern for the acquiror will be to ascertain in which states or countries the Target has operated. This will be significant in determining which regulators may have an interest in the proposed acquisition (discussed further in Chapter Four), as well as the law and regulation with which the Target is obliged to comply in the conduct of its business. It is not uncommon, especially in acquisitions of foreign insurance companies, that such companies may be selling policies within the U.S. to nationals of the foreign insurance company's home jurisdiction.

(1) Where Is the Target and/or Its Subsidiaries Established?

The acquiror will first need to establish where the Target and any of its subsidiaries are incorporated or otherwise established. For a U.S. insurer, the state in which it is incorporated will be its "domicile." Domicile determines the principal state regulatory regime which applies to the insurer's business. Similarly, if any of the Target or its insurance subsidiaries is incorporated in an EU country, it will be that country's law and regulation, and the regulator within that country, which has primary responsibility for the prudential regulation of that insurer.

(2) Where Else Is the Target and/or Its Subsidiaries Licensed?

A U.S. Target or its subsidiaries may have licenses to operate outside their U.S. state of domicile. They will certainly need these in any other U.S. state in which they have done or seek to do business. The acquiror

will wish to establish which states these may be and to ensure that all such licenses have been obtained and remain in good standing.

The position is slightly different across the EU. The twin freedoms of "establishment" and "provision of services" bestowed on EU insurers by the principal EC Insurance Directives mean that, once authorized by the "home state" regulator, they can establish branches or simply provide insurance directly into other EU member states without the need for separate authorizations or licenses from regulators in each of those Member States. This EU "passport" regime applies to branch offices of EU insurers, not to their subsidiaries: a subsidiary (as a separate corporate entity) will need its own authorizations (as to which, see Section 2.d(1) of this Chapter).

(3) Where Has the Target Carried Out Insurance Business?

As well as expecting the Target to have all necessary licenses or authorizations to carry on its business, the acquiror will also want some assurance that the Target has complied with whatever law or regulation applies to the day-to-day conduct of its business in all territories in which that business has been conducted. It is not always easy to determine where that business has been done. As a rule, the acquiror will be well-advised to enquire as to the territories in which the Target's policyholders are resident, as this will be a reasonable guide to the law and regulation which may apply to the conduct of the Target's business.

The state or territory of residence of policyholders will also be important in determining the extent (if any) to which policyholders may have rights to be consulted on or even to object to any aspect of the proposed acquisition, or to terminate their policies as a result.

e. Sales Practices and Compliance with Law/Regulation

Life insurance has given rise to its share of sales practice abuse, mis-selling and other market conduct claims around the world, particularly during the 1990's. In the U.S., state insurance regulators cracked down on the life insurance industry's practices in advertising policies, providing policy illustrations for products like "vanishing premium" life insurance and churning (external and internal policy replacements). Alleged sales practice abuses have also given rise to policyholder class action litigation against many major U.S. life insurers. Recently, the use by U.S. life insurers of "retained asset accounts" to hold death benefit proceeds has been the subject of intense regulatory scrutiny. In the U.K., the FSA and its predecessors have focused not only on churning but also on the mis-selling of personal pensions and endowment policies, resulting in fines for insurers and substantial compensation payments to policyholders. Mexican regulators have been heavily focused on false or misleading advertising in connection with policy sales.

Increased regulatory attention and policyholder litigation raise serious questions in acquiring a life insurer: What is the direct cost to the enterprise to investigate and settle these regulatory actions and policyholder litigation? Has the regulatory attention and policyholder litigation adversely impacted the ability of the insurer to retain old customers and attract new customers? Has there been any threat of downgrades by rating agencies because of these problems?

It is not only the life sector which has had the spotlight on its sales practices. The former New York Attorney General, Eliot Spitzer, made headline news, not only with his probe into the use of finite risk reinsurance, but also with his investigations into bid-rigging and contingent commission arrangements in the U.S. commercial property/casualty sector. The fallout from these investigations spread to the U.K. and elsewhere, with brokers and insurers alike reviewing their remuneration arrangements in the light of the issues raised by the Spitzer investigations.

The following sub-sections highlight some of the sales practice and other compliance issues in which an acquiror of an insurance business may have an interest as part of its due diligence.

(1) Contingent Commission Agreements

An acquiror should ascertain the extent to which the Target is (or has been) party to any Contingent Commission Agreements ("CCAs"). CCAs appear in various forms and guises but in essence they are all arrangements for payments to be made by an insurer to a broker in excess of agreed commission, in return for (and usually directly linked to) the placement of business by the broker with that insurer. They are not, in themselves, in breach of current insurance regulation either in the U.S. or in the U.K. but they must be treated with some caution — the broker is primarily the agent of the insured but is being remunerated by the insurer for placing business with that insurer and the potential for a conflict of interest is considerable.

While CCAs are not generally violative of state insurance laws, in 2004 the New York Attorney General brought civil suits against major U.S. brokers charging that CCAs constituted, among other things, fraud and conspiracy to restrain trade. The major U.S. brokers each settled in 2005 by establishing a restitution fund and agreeing to ban CCAs and disclose all commissions (the absolute ban on CCAs was lifted within the last year). On the insurance regulatory front, the NAIC adopted an amendment to its Producer Licensing Model Act labeled the Compensation Disclosure Amendment. Under the Amendment, if an insurance broker (or its affiliate) receives any compensation from the insurer, the insurance broker would, prior to the customer's purchase of insurance, be required to do the following: (i) obtain the customer's documented acknowledgement that the compensation will be received by the broker; and (ii) disclose the amount of compensation from an insurer and the method for calculating compensation. Failure to comply would deprive the broker from receiving the income. The Amendment must be introduced as proposed legislation and enacted into law in each

state to be made effective in each state. In light of these regulatory developments, review of disclosure practices of the major brokers of the Target should be part of due diligence review.

In the U.K., CCAs will be perfectly valid and binding as a matter of general law where the total payment from the insurer to the broker constitutes a reasonable remuneration for the introduction of the business. However, where the total payment from the insurer exceeds what is reasonable in the market and this has not been disclosed to and agreed with the insured in advance, the excess is likely to constitute a "secret profit" in the hands of the broker, which is illegal.

It is not just the broker who is potentially liable to the insured: the insurer may be jointly and severally liable with the broker to reimburse the insured the amount of any secret profit and this will inevitably be of concern to an acquiror, to say nothing of the adverse reputational effect that such arrangements may have on the Target.

On the regulatory front, the FSA has neither banned these agreements nor made disclosure of broker remuneration compulsory for non-life business in the manner applicable to life business: the limit of the FSA's regulatory intervention to date has been to oblige general insurance intermediaries to disclose details of commissions to any commercial (*i.e.*, non-retail) customer who requests that information. It has, however, noted the potential for CCAs to give rise to a conflict of interest and careful consideration should therefore be given to any CCAs which the due diligence process suggests may not have been disclosed to insureds.

(2) Discriminatory Underwriting

Most U.S. state insurance laws prohibit insurers from discriminating because of race, color, creed, national origin or disability. Some states have additional protected classes, including persons treated for a mental disability, children born out of wedlock, victims of domestic violence, past lawful travel and, for personal property or automobile insurance, the geographical location of the risk (*e.g.*, "redlining"). Prohibited

discrimination may include discrimination in setting premiums or rates charged for insurance, with higher premiums for protected classes, differences in insurance policy terms, rejection of applications for protected classes, refusal to sell insurance to protected classes or paying lower commissions to agents and brokers for the sale of insurance to protected classes.

Following the settlement of a race-based underwriting complaint between a major life insurer and the Florida Department of Insurance in 2000, race-based underwriting became a prominent subject of investigations by state insurance regulators, especially in connection with small face-value life insurance offered by some insurers. The New York Superintendent of Insurance required all licensed life insurers to review their past and current underwriting practices regarding race-based underwriting, to report their findings and specify actions taken or to be taken to remedy any unequal treatment. [4] Since race-based underwriting became a regulatory issue, it also became a due diligence issue. While the reports required to be submitted by licensed life insurers to the New York Superintendent of Insurance are not publicly available, in a negotiated transaction, the reports and remediation plans submitted to the New York Superintendent of Insurance and any other state insurance regulators could be requested as part of a due diligence review.

The EU currently has no equivalent anti-discrimination legislation specifically for the insurance industry. Much legislation prohibiting discrimination arises in the context of labor law and employment rights. Some arises in specific contexts, such as the U.K.'s Disability Discrimination Act, which makes it illegal for service providers (including insurers) to treat disabled people less favorably because of their disability (though insurers are able to justify refusing insurance to, or increasing premiums for, some disabled applicants where it is reasonable for the insurers to take the disability into account when

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[4] Circular Letter No. 19 (2000) (June 5, 2000) and Supplement 1 to Circular Letter No. 19 (2000) (June 22, 2000) (N.Y. State Ins. Dept.).

assessing risk). A potential acquiror should, however, bear in mind the EU Gender Directive, [5] which extends the principle of equal treatment between men and women beyond the field of employment and into the area of access to goods and supply of services, including insurance and other financial services. In its original form, the Gender Directive would have outlawed gender-based underwriting entirely and obliged many EU insurers to change existing practices by charging identical premiums for insurance regardless of the sex of the insured. The same principle would have applied to annuity payments.

However, the U.K. pressed hard for (and finally won) concessions, the effect of which was to permit gender-based underwriting if objective statistical data could justify the difference. Under Article 5 of the Gender Directive, Member States were permitted to allow "proportionate differences" in premium and benefits where the use of gender is a "determining factor" in the assessment of risk "based on relevant and accurate actuarial and statistical data," provided that Member States ensure that such data is "compiled, published and regularly updated."

Clearly, Article 5 of the Gender Directive provided an important exemption from the general prohibition. A legal challenge brought by the Belgian consumer group *Association Belge des Consommateurs Test-Achats* (Case C-236/09), led to this exemption being scrutinized by the European Court of Justice ("ECJ") for compatibility with the fundamental EU right of equal treatment of men and women. Advocate General Kokott's Opinion in this case states that a person's gender should not be taken into account as a risk factor in insurance contracts and recommends that the ECJ declare Article 5 (2) of the Gender Directive invalid as being incompatible with equal treatment of men and women which is enshrined as a fundamental right under EU law.

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[5] 2004/113/EC.

On March 1, 2011, in its final ruling on the case, the ECJ declared the opt-out in Article 5 of the Gender Directive to be void with effect from December 21, 2012. As of that date all Member States must therefore operate on the basis that the equality rules in the EU Gender Directive also apply to insurance pricing so that, for example, insurers will no longer be able to use statistics related to gender to help them calculate risks and set premiums for any product.

The full effects of the judgment have yet to be seen, although the insurance industry is forecasting that younger women will now pay significantly more for car insurance and that older men will receive significantly less pension income as a result.

In the U.K., the Gender Directive has been implemented by the Sex Discrimination (Amendment of Legislation) Regulations 2008 (the "Regulations"), which amended the Sex Discrimination Act 1975. The Regulations came into force on April 6, 2008, and apply to insurance contracts entered into on or after that date.[6] Under the Regulations, the use of gender as a factor in the assessment of insurance risk must be based on relevant and accurate actuarial and statistical data compiled, published and regularly updated in accordance with guidance issued by the U.K. Treasury. Any differences in treatment must be proportionate and must not result from costs related to pregnancy or maternity.

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[6] Insurers in the U.K. were already prevented from treating men and women differently under the Sex Discrimination Act 1975 (and in Northern Ireland the Sex Discrimination (Northern Ireland) Order 1976). The Sex Discrimination Act 1975, however, included an exemption allowing insurers to discriminate on gender grounds, provided it was with reference to "actuarial or other data from a source on which it was reasonable to rely" and the treatment was reasonable "having regard to that data and any other relevant factors." Consequently, insurers have continued to take gender into account in the calculation of premiums and benefits in life and critical illness policies, annuities, private medical insurance, travel insurance, motor insurance and other types of cover where data shows that the gender of the insured can have an effect on the risk. The Gender Directive did not alter that position, but restricted the scope of the exemption.

Direct discrimination in the provision of services on the grounds of gender reassignment is also prohibited, subject to the same insurance exemption regarding the use of actuarial and statistical data. The Regulations confirm that insurance and related financial services can be provided to members of only one gender in relation to risks that affect only that gender.

In its due diligence review, an acquiror would be well advised to enquire as to the Target's ability to justify any gender-based discrimination on premiums, as lack of this could have a profound impact on the Target's business.

It should be noted that some EU Member States have implemented the Gender Directive in a form that prohibits the use of gender as a rating factor in any circumstance. Again, an acquiror should consider this if the Target is, or has, non-U.K. operations in the EU.

Moreover, anti-discrimination law in the EU and U.K. in the provision of goods and services continues to develop. On July 2, 2008, the European Commission issued a new draft Equal Treatment Directive, which is aimed at providing protection outside the workplace from discrimination on grounds of age, disability, sexual orientation and religion or belief. The European Parliament and European Council are currently negotiating the terms of this Directive. Once passed, Member States will have two years to implement it into national law.

The draft Equal Treatment Directive has a broad remit, covering the provision of social services, healthcare, education and housing as well as access to and the supply of goods and services, including insurance. Discrimination on grounds of gender, however, is not included and will continue to be addressed by the Gender Directive.

The draft Equal Treatment Directive includes an important exception that would apply to insurance and is similar to that provided by the Gender Directive. Article 2, paragraph 7 of the Equal Treatment Directive provides that "in the provision of financial services Member States may permit proportionate differences in treatment where, for the product in question, the use of age or disability is a key factor in the

assessment of risk based on relevant and accurate actuarial or statistical data."

In the U.K., the Government has consolidated anti-discrimination legislation into the Equality Act 2010, which also prohibits disability and age discrimination in the provision of goods and services. The U.K. Equality Act 2010, enacted on April 8, 2010, prohibits conduct that discriminates directly or indirectly against someone with a "protected characteristic." There are nine such characteristics: (i) age, (ii) disability, (iii) gender reassignment, (iv) marriage and civil partnership, (v) pregnancy and maternity, (vi) race, (vii) religion or belief, (viii) sex and (ix) sexual orientation.

The Equality Act 2010 includes provisions that apply to insurance. For example, in connection with the provision of services generally, Clause 31 of the Act clarifies that, if an employer arranges for an insurer to provide his employees with a service, such as a group health insurance scheme, the insurer, not the employer, is the service provider and the employees will be regarded as a section of the public. Exceptions relating to insurance are covered in Schedule 3, Part V. To a great extent these mirror pre-existing legislation in relation to disability, sex, gender reassignment, pregnancy and maternity. Insurers will not be in breach if they continue to apply terms in policies that were entered into before the relevant provision came into force. However, where pre-existing policies are renewed or their terms are revised after that date, they will have to comply.

(3) Slavery Reparations

U.S. insurance companies have been potential defendants in at least two class action suits aimed at obtaining reparations from those companies which profited from the enslavement of African-Americans prior to 1865. A similar claim was lodged against the Society of Lloyd's in the U.K. in 2004.

The consolidated federal lawsuits were dismissed, as was the claim against Lloyd's. However, proponents of the reparations movement have vowed to continue to pursue their claims vigorously along both judicial and also legislative avenues. The presence of the reparations movement, coupled with the as-yet unknown potential liability and the prospect of reputational damage, raises two basic concerns that should be addressed in a due diligence review of any U.S. Target: Did the Target (or any predecessor in liability) exist before 1865 (when slavery in the U.S. was finally abolished), and, if so, did it insure slaves? Has the Target previously acquired any company (including, but not limited to, insurance companies) whose corporate history has any link with the institution of slavery? A potential acquiror should request and review any information submitted to any state by the Target that describes the Target's history of insuring slaves.

(4) Retained Asset Accounts (U.S. Life Insurers)

During the summer of 2010, the New York State Attorney General and other government offices announced a series of investigations into the use by U.S. life insurers of "retained asset accounts" established to hold the proceeds of life insurance policies after the death of the insured. The life insurer issues drafts to the beneficiary that may be used to draw upon all or part of the account at any time and interest accrues on the amount held. The assets that support the account are typically held in the life insurer's general account, and the insurer bears the risk of investment losses and retains any profits from excess investment returns. The funds in the accounts are not guaranteed by the Federal Deposit Insurance Corporation but generally are covered by state life and health insurance guaranty associations. In November 2010, the National Conference of Insurance Legislators approved its "Beneficiaries' Bill of Rights" on retained asset accounts and, in December 2010, the NAIC updated its 1994 sample bulletin for state insurance regulators to issue relating to retained asset accounts. Both govern the use of retained asset accounts and require additional disclosure of terms to policyholders. Many states have taken various

approaches to setting standards for retained assets accounts – statutory amendments, regulations and bulletins. New York issued guidance in 2012 that makes a lump sum payment _______ default option – selection of a retained asset account requires affirmative election by the beneficiary. Acquirors may wish to consider seeking specific information regarding a life insurer's use of retained asset accounts, and in particular the status of any ongoing government investigations or any pattern of policyholder complaints on the topic.

(5) Escheat Laws (U.S. Life Insurers)

2011 brought escheat law audits and legislative proposals to the U.S. life insurance industry. State insurance regulators, state comptrollers and state attorneys general began claiming that life insurers were not doing enough to find out whether their insureds had died or to locate beneficiaries and settle claims when the insurer learned, through matches with the Social Security Administration Master Death File database or otherwise, that their insureds have died. In July, 2011, the New York Department of Financial Services served a demand for a "Section 308" special report on all New York-licensed life insurers to produce information regarding cross-checking their insureds against the Master Death File for persons who may have died but had not submitted claims for insurance benefits. Notwithstanding the Department's probe, in November 2011, the New York Attorney and New York State Comptroller announced that they had "teamed up to ensure proper payment of life insurance benefits." The National Conference of Insurance Legislators responded by proposing a Model Unclaimed Life Insurance Benefits Act that requires a cross-check of in-force policies against the Death Master File at least quarterly. The New York Department of Financial Services promulgated a regulation on the subject in 2012 that imposed substantial burdens on insurers doing business in New York. Acquirors may wish to consider seeking specific information regarding a life insurer's escheat law compliance and compliance audits.

f. Relationship with Regulators

For an insurer, as with any other financial services provider, relationships with regulators are key: regulators ultimately have the power to prevent the insurer from conducting its business and it is inevitable that any due diligence exercise will focus on the Target's regulatory standing.

Certain aspects of the Target's relationship with its regulators, which are of particular significance to an acquiror's due diligence, are considered below. As a general point, however, an acquiror will generally ask to see copies of all non-routine correspondence which the Target may recently have had with its regulator.

(1) Market Conduct Examinations/Inspection Visits

Since the advent of the "market conduct" problem in the 1990s, U.S. life insurers are subjected to routine and targeted market conduct examinations by state insurance regulators. These are usually conducted separately from any financial examination. An acquiror will therefore wish to seek information about these market conduct examinations to ascertain (in particular) the manner in which the Target has been selling and servicing its products, especially in the areas of pricing, issuing policies and claims practices. Since the applicable market conduct rules are usually those of the state in which the policy is sold or delivered, if an insurer offers insurance policies in multiple states, the insurer may be subject to market conduct examinations by multiple states.

Insurers in the U.K. are also likely to have undergone inspection visits from the FSA, though the frequency of these will depend on the perceived degree of risk proposed by the insurer: that risk is assessed by the FSA in the light of the length of time the insurer has been established, business written and modus operandi (the so-called "Arrow" risk assessment framework). A prudent acquiror will ask about the frequency of these inspection visits, issues arising from them and

whether any concerns have been dealt with, along with copies of any FSA reports prepared following any such visits.

Regulators in Asia conduct similar investigations periodically and in certain countries, such as Taiwan, the regulators' reports are considered as being owned by the regulators and the Target is prohibited by law from furnishing copies to a potential acquiror. Similarly, in Singapore, the license itself is considered to be owned by the government and cannot be furnished to a potential acquiror. Work-arounds such as representations, warranties and other measures often need to be adopted.

(2) Complaints and Litigation

Most regulators require insurers to maintain a complaint log. An acquiror will wish to review this log and copies of any material complaints that have been lodged against the Target to determine, *inter alia*, whether complaints follow a pattern indicative of a systemic problem with the Target (*e.g.*, dubious sales practices, ambiguous policy forms or questionable claims practices).

Information on complaints may also reveal the degree of satisfaction (or otherwise) displayed by the Target's regulator towards the Target's all-important complaints handling process.

Some complaints may become litigious. It will be similarly important for an acquiror to seek information about current and recent litigation with policyholders (and others) in which the Target has been involved. The importance of reviewing any litigation between the Target and its reinsurers has already been noted.

(3) Disciplinary Proceedings

In addition to customer complaints and litigation, the acquiror will want to know whether the Target has been or is likely to be the subject of any investigation or disciplinary proceedings initiated by its regulator. The

acquiror will also want information about any fines or other penalties, which a regulator has levied, whether publicly or otherwise.

(4) Commitments, Undertakings and Requirements

In addition to complying with law and regulation as it applies to all insurers, the Target may, either through agreement with or compulsion by its regulator, be obliged to meet certain other regulatory criteria which are specific to its business. In the U.S., these are usually referred to as commitments and undertakings. In the U.K., they are more commonly known as requirements.

These undertakings may cover matters such as limitations on payment of shareholder dividends, restrictions on operations or a requirement to gain prior regulatory approval before taking certain steps. They may also relate to the insurer's solvency requirements.

An acquiror should enquire as to the existence, and request copies, of all such matters to determine their potential effect on its objectives for the acquisition. An acquiror will also wish to assess the extent to which it may be possible to procure the Target's release from any such commitments and can factor the need to approach regulators on this point into discussions as to the regulatory consents which may be needed to complete the acquisition.

g. Consumer Privacy/Data Protection

Consumer privacy and data protection issues have previously been considered in the context of how the due diligence exercise as a whole should be conducted. Aside from this, an acquiror will be concerned to know that the Target has conducted its day-to-day business in accordance with all applicable consumer privacy and data protection requirements.

In the U.S., state regulations based on NAIC model consumer privacy regulations generally protect nonpublic personal financial and personal

health information. Many states allow disclosure subject to an ability of a consumer to opt-out of disclosure following notice by the insurer. As part of due diligence, the Target's privacy policies should be reviewed for the purpose of identifying the following: (i) determining the Target's current privacy policies regarding the personal financial and health data of its customers and its policyholders (including beneficiaries of group policies), (ii) whether the privacy policies are consistent among divisions of the Target and its affiliates, (iii) the manner and form in which customers and policyholders are given notice of privacy policies, both in the case of Internet transactions and traditional commerce, (iv) whether customers have an opportunity to "opt-in" or "opt-out" of having their personal data shared with affiliates or non-affiliated third parties, (v) the manner in which the customer's choice is recorded by the Target, (vi) whether the Target has centralized recordkeeping to keep track of customer or policyholders' decisions concerning use of personal data, (vii) whether there are any instances where the Target deviated from its own privacy policies, and if so, what actions were taken by the Target, and (viii) whether there are any instances where the security of personal data has been compromised, whether by unauthorized employee access, by hackers or otherwise, and if so, what actions did the Target take in response to these events.

Stock purchase transactions in the U.K. do not, as a rule, give rise to many complicated data protection issues (by contrast with asset purchases, discussed in Section 4 of this Chapter). However, an acquiror will still wish to ascertain a number of factors: whether the Target has given all necessary notifications to the U.K.'s Information Commissioner as to the type of personal data it holds and the purposes for which it will be processed; whether any third parties are used to process personal data (for example, claims handling companies) and, if so, whether those arrangements are compliant with data protection legislation; whether the Target has received complaints or been the subject of investigations relating to its processing of personal data. In particular, the acquiror will wish to know whether the consents obtained from policyholders by the Target at the time their policies were taken out, as to the use of their personal data, cover the purposes for which

the acquiror may wish the Target to use it in future (*e.g.*, to cross-sell other products). If not, the Target could incur considerable expense and inconvenience in having to obtain new consents post-closing.

h. Money Laundering Requirements

There has been a widespread trend towards fighting crime by making it more difficult for the proceeds of crime to slip unnoticed into domestic economies via reputable financial institutions. This trend has been reflected in various regulatory provisions that require financial institutions to adopt due diligence processes designed to verify the identity of their customers and to implement internal control systems to monitor their customers' activity, all with the aim of identifying and interdicting criminal or other potentially suspicious proceeds or activities. This trend has been marked by a new urgency since the events of September 11, 2001 and the heightened concern for the risk of terrorist financing. Both the U.S. and U.K. have responded to these events by introducing major legislation designed to combat terrorist financing activities.

(1) U.S.

On October 26, 2001, President Bush signed sweeping anti-terrorism legislation in response to the September 11 attacks. The stated purposes of the new legislation, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001[7] are to "deter and punish terrorist acts in the United States and around the world, to enhance law enforcement investigatory tools, and for other purposes." Of particular importance to financial institutions, including insurance companies, mutual funds and registered broker-dealers, is Title III of the Act

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[7] Pub. L. No. 107-56 (2001).

entitled the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001. This Title imposes strict compliance and reporting requirements on insurance companies, mutual funds, broker-dealers and other financial institutions and exposes them to expanded regulatory scrutiny, as well as potential civil penalties and criminal liability. In particular, life insurance companies, mutual funds and broker-dealers for the first time have been required to establish anti-money laundering programs and suspicious activity reporting programs. The Act also provides enhanced law enforcement powers for the investigation and prosecution of money laundering and the financial institutions that participate in or facilitate it.

Under rules issued by the U.S. Department of the Treasury, life insurance companies in the U.S. were required to implement an anti-money laundering program effective May 2, 2006. This program must at a minimum include (i) the implementation of internal policies, procedures and controls designed to prevent the insurance company from being used to facilitate money laundering or terrorist financing, (ii) the designation of a compliance officer to administer the program, (iii) the provision of ongoing training to employees, and (iv) the provision of independent testing to monitor the effectiveness of the program. Life insurance companies are also required to implement a program for reporting to the appropriate authorities any suspicious transaction or activity involving customers of the companies (an "SAR" filing). An important element of due diligence in the acquisition of a life insurance company in the U.S. will be confirmation that the company has implemented an effective anti-money laundering program and suspicious activity reporting program as required by these rules.

(2) U.K.

The U.K. has broadened the scope of its anti-money laundering legislation in recent years to cover the proceeds of all crimes, not just terrorism and drug-trafficking. The key legislation is the Proceeds of Crime Act 2002, the Terrorism Act 2000 and the Money Laundering

Regulations 2007 (the latter implementing in the U.K. the third EU Money Laundering Directive). The FSA is responsible for enforcing the Money Laundering Regulations 2007. The FSA's requirements in respect of money laundering are currently contained in its Systems and Controls Sourcebook ("SYSC"). These state that the FSA will look to guidance for the U.K. financial sector issued by the Joint Money Laundering Steering Group to determine whether an insurer's money laundering procedures are appropriate.

The keystone of the FSA's money laundering requirements is that insurers should verify the identity of new and existing customers and keep records to that effect for prescribed periods. Insurers must also monitor and report suspicious transactions and set up and operate arrangements, including the appointment of a money laundering reporting officer, to ensure that they can comply with the money laundering principles embodied in SYSC.

The FSA has imposed significant fines on organizations which do not comply with its money laundering requirements and a potential acquiror will want to verify the existence of and compliance with a suitable anti-money laundering program within the Target. This is not only important to establish compliance with SYSC; the Proceeds of Crime Act 2002 creates a number of criminal offenses which could give rise to prosecution of insurers and their staff and makes compliance with a suitable anti-money laundering program of more than purely regulatory or reputational significance.

i. Blocking and Economic Sanction Requirements

Special issues may arise in a cross-border acquisition by a U.S. insurer because of a series of blocking and economic sanction regulations administered by the Office of Foreign Assets Control ("OFAC"), a unit of the U.S. Department of the Treasury. OFAC administers laws and regulations that block transactions and otherwise impose economic sanctions on specific countries, such as Cuba, Iran, North Korea and the Sudan, and on specific individuals or entities, known as "specially

designated nationals," including "specially designated terrorists" and "specially designated narcotic traffickers." OFAC's jurisdiction extends to U.S. persons, meaning U.S. citizens and U.S. companies, including their foreign branch offices, and under the Cuban and North Korean sanction programs, to foreign subsidiaries of U.S. companies. In addition, U.S. persons are generally prohibited from "facilitating" transactions by foreign persons, including their subsidiaries, with other sanctioned countries. For example, acquiring a non-US company that sells policies in Cuba or to Cuban nationals, or that writes travel health policies that allow a traveler to obtain medical services in Cuba, could be problematic, as could acquiring a company that has reinsurance arrangements that reinsure risks in OFAC sanctioned countries.

It is important for a U.S. acquiror to determine whether a foreign Target is doing business with a sanctioned country or its nationals because the existence of such business will present difficult compliance problems for the U.S. acquiror.

j. Anti-Bribery Rules

Many countries have rules that prohibit the bribing of public officials for the purpose of obtaining business, the most notable law being the U.S. Foreign Corrupt Practices Act (the "FCPA"). Although due diligence related to anti-bribery rules should be a standard item on the due diligence checklist for any acquisition of any company, potential bribery issues can be present in unique ways with insurance companies. For example, it is not uncommon for Asian companies to take their regulators on golf trips, to pay the travel expenses of spouses accompanying regulators to a conference, or to pick up restaurant bills for them. Under certain circumstances, such conduct could violate the FCPA. Similarly, many U.S. insurance companies have joint ventures or minority investments in companies operating in countries where bribing public officials is commonplace.

k. Unusual or Onerous Features In Policy Terms and Conditions

An acquiror will generally want to examine a representative sample of the policy forms or other documentation evidencing the terms upon which the Target has underwritten its insurance business. This is relevant to an assessment of the adequacy of the Target's reserves but it is also important for the acquiror to ascertain whether the Target has written business on terms which may present strategic or other problems for the acquiror going forward. Guaranteed benefits are one example of a seemingly innocuous term, which turned out to be an onerous commitment for insurers, but there may be others. A unilateral right for policyholders to increase their levels of cover under income protection policies without medical underwriting or premium review in a market where claims experience is deteriorating, for example, could be another.

l. Bad Faith Payment Claims

When acquiring a property/casualty company, particularly one that insures catastrophic risk, it is important to review the claims payment history to determine if the insurer has a history of not promptly paying claims. If so, further investigation would be needed into whether there is any policy or practice followed relating to late payment of claims that could give rise to allegations of bad faith. Additional attention should be paid if any catastrophes recently occurred, such as a hurricane, wind storm, flood or earthquake.

3. STOCK PURCHASE STRUCTURE

a. The Structure of Agreement

(1) Regulatory Approval and Merger Control Clearance As a Condition to Closing

Chapter Four looks in some detail at the regulatory approval requirements for a stock purchase deal, while Chapter Five considers merger control issues. This section looks briefly at how the need to obtain these various approvals or clearances often has an impact on the structure of a stock purchase deal.

In the U.S., the generally-accepted view is that offering to acquire control of an insurer, or entering into an acquisition agreement, conditional upon obtaining regulatory approval, does not contravene the regulatory approval requirements of state insurance holding company acts. A similar position prevails in most European, Asian and South American countries. In the U.K., for example, the relevant legislative provisions require notice to be given to the FSA by a person "who decides to acquire or increase control" of an insurer. This generally means that regulatory approval needs to be obtained before a "controlling" holding of shares is acquired or before an unconditional commitment to acquire a "controlling" holding of shares is accepted.

It is unusual, though not impossible, to obtain insurance regulatory clearance before the stock purchase agreement is even entered into. However, this increases the likelihood that the proposed acquisition will become public before the stock purchase agreement has been signed and, for a variety of reasons, may therefore be undesirable. By far the most common structure is for an insurance stock purchase agreement to be entered into conditional upon regulatory approvals being obtained. Assuming these applications are filed promptly post-signing, the parties can still expect closing to take place at least a month (and often much longer) after signing.

The same point arises in respect of merger control clearances: the parties are unlikely to want to seek these (and are not usually obligated to do so) before entering into the stock purchase agreement but they will wish to obtain any that are required before the transaction closes.

In many countries in Asia and South America, it is generally advisable to have informal discussions with the regulator prior to signing a Stock Purchase Agreement. Many such regulators could take offense by "reading about it in the papers," so prior notification is advisable to keep up good relations. In some cases, having such discussions can help a seller determine if its potential buyer is going to have any problems with the regulators, which can be quite significant if the seller has multiple bidders. Additionally, it may be possible to get a sense of whether the regulators are likely to impose any significant conditions on the granting of their approval.

(2) Closing/Post-Closing Adjustments to Purchase Price

The delay between signing and closing the deal can have consequences for the economics of the transaction: the parties will have based their price on the financial condition of the Target at signing, which may change in the intervening period. Two issues are typically presented: (i) any updating of the financial information through the signing (given that such information cannot be instantaneously produced), and (ii) the performance of the business between signing and closing. It is quite common for the stock purchase agreement to include an adjustment mechanism to adjust the purchase price based on the receipt of financial information showing performance of the business through the signing date. More negotiated is whether there will be a purchase price adjustment based on performance of the business between signing and closing, as both sides may be concerned about whose ox is being gored by agreeing or not agreeing to such a provision. It is not uncommon to see certain items, such as changes in the value of the Target's investments, treated differently from the rest of the purchase price adjustment provisions.

(3) Adverse Development Reinsurance

In a U.S. stock purchase transaction for a property/casualty insurer, it is not uncommon for an adverse development reinsurance agreement to be used as a substitute or supplement to seller indemnification. The purpose of such a reinsurance agreement is to protect an acquiror against the risk that the reserves for the property/casualty business are inadequate. A stop-loss treaty requires the seller (or its insurance company affiliate) to enter into, a moment before closing, a reinsurance agreement with the Target. The agreement generally provides that, with respect to the Target's in-force business (*i.e.*, business written at or prior to the closing), if the losses that emerge over time exceed "X," then the excess over "X" will be borne by the seller or its affiliate. In effect, this stop-loss treaty shifts the risk of under-reserving back to the seller. This is similar to post-closing indemnification for breach of a representation as to adequacy of reserves.

The parties will want to give careful attention to the accounting treatment of adverse-development reinsurance. It is more attractive to treat such reinsurance through prospective accounting, as permitted when treated as a guarantee given in a business combination (APB Opinion No. 16), rather than by retroactive accounting, as suggested by FASB Standard of Financial Standards No. 113 (with any gain recognized over the loss settlement period). The Emerging Issues Task Force of the Financial Accounting Standards Board has stated (EITF Topic No. D-54) that GAAP will allow the seller of an insurance enterprise, under specified conditions, to account for an adverse-development cover as prospective reinsurance, so that any resulting gain is recognized at the time of sale. It is important to consult accounting experts at an early stage, if adverse development reinsurance is to be used.

(4) Financial Assistance Issues In the U.K. and Elsewhere in Europe

Where the Target is part of a larger group of companies, some kind of pre-sale reorganization of assets and liabilities intra-group may be required. The transfer of a portfolio of business into or out of the Target is one such possibility (this is considered in Section 4 of this Chapter). However, there are others, for example, the commutation of intra-group reinsurance or transfer of real estate interests. Closing provisions in the stock purchase agreement may provide for repayment or forgiving of intra-group debts.

Throughout the transaction, the acquiror will need to bear in mind the potential for any of these types of seemingly innocuous arrangements to give rise to unlawful "financial assistance," where the Target and/or its subsidiaries are U.K. (or continental European) companies. Prior to October 1, 2008, section 151 of the U.K. Companies Act 1985 made it unlawful for a company or any of its subsidiaries to give financial assistance (whether or not to the acquiror) directly or indirectly for the purpose of the acquisition of shares in that company. The prohibition applied to assistance given before, at or after completion of the sale. Breach of it was a criminal offense.

There was no definitive list of what constituted financial assistance but the Companies Act 1985 did list some examples, such as having the company whose shares are being acquired (or any of its subsidiaries) provide a loan, waiver, some form of security or an indemnity. There was a "catch all" provision in section 152 of the Companies Act 1985 for any other arrangement which reduced the net assets of the company to a material extent (or which took place when the company had no net assets).

The Companies Act 1985 set out a procedure, commonly referred to as "whitewashing," so that (where the Target is a private company with net assets) the Target could effectively sanction the financial assistance. The procedure required each of the directors to make a statutory declaration to the effect that the company will not be unable to pay its debts once

the assistance has been given and will continue to be able to pay its debts as and when they fall due for the next 12 months. These declarations had to be declared reasonable by the company's auditors. The company's net assets should not be reduced as a result of the giving of the assistance (or, if they are, the assistance must technically come from what in the U.K. are called "distributable reserves," such as retained profits).

In 2005, the U.K.'s Company Law Reform Bill was published, containing a number of key proposals for amending and simplifying U.K. company law. One of these proposals was to abolish the section 151 provisions in respect of private companies altogether. These proposals were adopted into U.K. law with the passing of the Companies Act 2006, and on October 1, 2008, the financial assistance prohibition and the whitewashing procedure set out in the Companies Act 1985 were repealed in so far as they applied to the giving of financial assistance by a private company for the purposes of the acquisition of shares in itself or another private company.[8] Under the new company law regime public companies remain prohibited from giving financial assistance for the purpose of the acquisition of their shares or those of a parent company,[9] and private companies from giving financial assistance for the purpose of the acquisition of shares of a public parent company.

The repeal of the financial assistance prohibition for private companies is likely to lead to fewer complicated acquisition structures designed to avoid the prohibition, and a reduction in advisory fees paid by private companies to ascertain the application of the regime. However, the Companies Act 2006 fails to address a number of existing uncertainties that will continue to cause concern in the application of the financial

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[8] Companies Act 2006, § 1295 and sched. 16; Companies Act 2006 (Commencement No. 5, Transitional Provisions and Savings) Order 2007, art. 5(2).

[9] Companies Act 2006, part 18, ch. 2.

assistance rules for public companies (such as, somewhat startlingly, the actual meaning of the words "financial assistance"). Further, the directors of the Target will need to be satisfied that the particular financial assistance contemplated will be consistent with their duties under the Companies Act 2006, in particular, the rather all-embracing duty to "promote the success of the Company" under section 172.

b. Key Representations and Warranties

In most jurisdictions, the purpose of representations or warranties is twofold:

- they force the seller to disclose what it knows, or could know through reasonable enquiry, about the business being sold (this is important in jurisdictions where the principle of "caveat emptor" prevails); and
- they go some way to apportioning the risk of facts which are unknown and not discoverable through reasonable enquiry between the seller and the acquiror.

In the U.S., it is common for statements of fact against which the seller is intended to disclose conflicting information to be expressed as representations and warranties. U.S.-style agreements often contain an indemnity by the seller for inaccuracies in the representations and warranties. The scope of such indemnity is often the subject of extensive negotiation on matters such as caps, baskets and survival periods.

In the past, it was common practice for stock purchase and asset acquisition agreements governed by U.K. law to provide, in a similar way, that warranty statements were given both as warranties and representations. However, case law shows that this approach did not find favor with the courts, who would be most likely to reject a misrepresentation-type claim based on a warranty expressed to "double" as a representation. The practice has therefore generally died out.

Some matters do not sit comfortably within the representation and warranty mechanism. Undisclosed liabilities are one such example, where a warranty to the effect that there are none may be of little use to the acquiror if there are. Disclosure of an actual or potential liability in response to representations and warranties will make it difficult, if not impossible, for the acquiror to make a warranty claim based on that liability in future. In cases such as these, the issue is not one of price adjustment but of the acquiror's ability to buy the business without suffering the adverse economic consequences of a particular liability at all. In such cases, an indemnity will often be appropriate.

(1) Representations and Warranties Common to Other Industries

A stock purchase agreement for an insurance company ordinarily contains a full set of representations and warranties common in any acquisition agreement (relating to ownership of the stock, absence of material adverse change, absence of undisclosed liabilities, etc.). In addition, it will contain representations and warranties specifically tailored to the insurance business and we have considered some of these below.

(2) Financial Information

For a U.S. insurer, there are three common representations and warranties regarding its financial statements. First, there is ordinarily a representation regarding the accuracy of the GAAP financial statements of the Target. If the Target is a holding company, then the financial statements provided to the acquiror will be consolidated statements of the Target holding company and its insurance (and other) subsidiaries.

Second, an acquiror will seek a representation regarding the accuracy and completeness of the audited and unaudited financial statements of each insurer subsidiary determined in accordance with U.S. statutory

accounting practices. U.S. statutory accounting practices do not permit consolidation.

Third, an acquiror will seek a representation concerning the filing by each insurer, as well as the compliance with applicable law, of the required statutory financial statements with the state insurance regulator in its state of domicile and in each state where it is licensed.

For a U.K. insurer, the usual financial warranties are not dissimilar but will reflect the difference in financial information which U.K. insurers are obliged to file.

There will generally be a warranty to the effect that the last audited financial statements of the Target (generally comprising a balance sheet and profit and loss account) are accurate and have been prepared on a basis consistent with previous years and a separate warranty (usually included in the compliance, rather than the financial, warranties) as to compliance with all obligations to file annual (or more frequent) regulatory returns with the FSA, which returns are materially accurate and compliant with applicable U.K. law and regulation. It is not generally appropriate for the wording of the accounts warranty (which, where it relates to audited accounts, may use expressions such as "true and fair view") to apply to the returns warranty; the financial information in each set of materials will have been compiled on quite different bases and for quite different purposes.

(3) Adequacy of Reserves

Another representation often requested by acquirors concerns statements related to the Target's reserves, or the calculation of reserves in accordance with an agreed set of actuarial or accounting standards. This representation is invariably contentious, particularly in the case of acquisitions of property/casualty insurance companies, where the adequacy of reserves can be a highly subjective determination. Acquirors should not be surprised to find that a seller refuses to provide what is in effect a guarantee of the reserves, particularly in circumstances

where the acquiror has had ample opportunity to conduct its own actuarial assessment of them as part of the due diligence process.

(4) Actuarial Reports and Accuracy of Information

Particularly where an insurance business is being auctioned in a formal sales process, the seller will often have arranged, prior to commencement of the due diligence process, for a firm of consulting actuaries to carry out a reserve study. This report will then be made available for the acquiror to consider in conjunction with its own actuarial advisers. The seller will usually be asked to represent that it has supplied the consulting actuaries with all the information that was required by the actuaries and that the information supplied was true and correct. The representation may also state that the actuaries formulated their own conclusion, based on the information provided to them, and that the acquiror has been provided a true and complete copy of the actuaries' report.

(5) Existence of Regulatory Licenses and Compliance

A representation is also typically sought regarding the regulatory status of the Target, including the existence of all licenses and authorizations required for the conduct of its business and the absence of proceedings against the Target to have any of them limited, suspended or revoked.

The acquiror will also generally seek to include a seller representation regarding compliance by the Target with all applicable law and regulation in any jurisdiction in which it has conducted business.

(6) Undisclosed Liabilities

Since it is impossible for an acquiror to evaluate insurance liabilities of which it is unaware, it is usual to seek some representation from the seller that the Target has no insurance liabilities which have not been

disclosed and that all insurance business which has been written is on terms not materially different from those which have been disclosed as part of the due diligence exercise. These representations are often teamed with an indemnity from the seller to cover any such liabilities which may appear in future. These representations (and the indemnity) may be particularly important where the acquiror is making entirely its own assessment of the adequacy of measures, with no assurances or guarantees from the seller.

4. ASSET PURCHASE STRUCTURE

a. Options In Relation to the Transfer of the Target's Insurance Business

Insurance policies are contracts, like any other. In theory, there is no reason why an insurer, wishing to transfer some or all of its outstanding insurance obligations to another insurer, could not approach each of the relevant policyholders individually to obtain their participation in the novation of each of their insurance contracts.

While this may be practicable where the block of business concerned is small and limited to commercial customers, it is difficult to see how this would work for a substantial portfolio of individual policyholders.

As a result both the U.S. and the U.K. (along with other continental European countries) have devised alternative methods of achieving a similar result.

(1) Transfer of U.S. Insurer's Obligations to Purchaser

In the U.S., a bulk reinsurance transaction is commonly used as a means of acquiring an in-force block of business: all or part of the outstanding insurance of the ceding company is effectively transferred by the ceding company to a reinsurer. In the context of an acquisition of the Target's entire business (as opposed to its stock), the reinsurer will also purchase

assets such as furniture and fixtures, files and records, and offices and become the employer of certain employees of the ceding company.

The ceding company pays a "reinsurance premium," which may at the closing be netted against the purchase price. The "purchase price" or "ceding commission" in a bulk reinsurance transaction can effectively be viewed as the excess of the liabilities assumed over the net amount of the assets transferred — the net benefit of consideration to the ceding company.

Bulk reinsurance is only available as an alternative to a stock purchase if the purchaser or one of its affiliates is an insurer and has the necessary license or authority to write the lines of insurance that the Target has in-force. It may take either of two forms:

Indemnity Reinsurance. In this case, the insurance policies remain contractual obligations of the original insurer. Under an indemnity reinsurance agreement, the original insurer looks to the reinsurer for indemnification to pay any losses. It will often encompass a transfer of the obligation to administer the business to the reinsurer as well. In any event, the policyholders of the original insurer do not have a right to seek payment directly from the reinsurer unless the reinsurance agreement specifically provides for that contingency (usually through the inclusion of what is known as a cut-through provision). The sale of a book of business that is renewable annually, such as property/casualty insurance or indemnity health insurance, is particularly suited to an indemnity reinsurance of expired and in-force policies coupled with (i) the buyer or its affiliate agreeing to administer the expired and in-force policies, and (ii) the sale to the buyer of the exclusive right to renew existing business on policies issued by the buyer or its affiliates.

Assumption Reinsurance. This (which is sometimes referred to as "substituted insurance") refers to situations in which the reinsurer takes on 100% of the original company's primary obligations to the policyholder. When bulk reinsurance is effected on an assumption basis, the reinsurer will mail an assumption certificate to every policyholder (or to all in-force policyholders and policyholders who do

or might have claims). The certificate, signed by the reinsurer, stipulates that the reinsurer will assume the direct obligation of the policyholder and that all future policy premiums are to be paid to and all claims must be presented to the reinsurer. In contract law terms, assumption reinsurance is intended to effect a novation of the ceding insurer's outstanding policies.

Policyholders may be asked to consent to the novation, either by signing a consent or by paying renewed premiums to the assuming reinsurer. Without policyholder consent, there is a substantial issue as to whether assumption reinsurance is effective to novate the relevant policies: if not, the ceding insurer will not be released from further liability under the "transferred" policy and could be exposed to that liability, especially if the assuming insurer becomes insolvent. Because of this risk, many bulk reinsurance transactions involving long-term liability such as life insurance (which, on the face of it, would be best suited to assumption reinsurance) are actually structured as indemnity reinsurance in which the reinsurer will also take on the responsibility to administer the reinsured business. In addition, in order to protect the ceding insurer from the credit risk of the reinsurer, the arrangement may also include a requirement that assets be deposited by the reinsurer in trust for the benefit of the ceding insurer to secure reinsured policy obligations under certain events such as a rating downgrade of the reinsurer.

Insurance Regulatory Consents. The laws of the state of domicile of both the ceding company and the reinsurer must be examined to determine whether the consummation of either type of bulk reinsurance agreement, indemnity reinsurance or assumption reinsurance, requires the prior approval of the state insurance regulator. While approval is not required in most states where the Target and acquiror are merely licensed as foreign insurers, there are some states (notably California, New York (life insurers only) and Wisconsin) whose laws must be examined. As a general rule, assumption reinsurance transactions tend to be subject to a greater number of non-domestic state approval requirements than indemnity reinsurance transactions. Notably, the Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted

in July 2010, includes a sweeping provision that nullified these non-domestic state filing and approval requirements effective beginning July 21, 2011. At the time of this writing, only one state, California, has issued guidance on how it will act in response to the preemption provisions of the Dodd-Frank Act. California has stated that it will honor the Dodd-Frank Act preemption provisions.

Pre-Acquisition Notice Based on Market Share. Section 2.b(2) of Chapter Four describes state "market share" statutes as they apply to an acquisition of control of a U.S. insurer. These laws typically apply to an "acquisition" which is defined to mean "any agreement, arrangement or activity the consummation of which results in a person acquiring directly or indirectly the control of another person, and includes but is not limited to the acquisition of voting securities, the acquisition of assets, *bulk reinsurance* and mergers" (*emphasis added*).[10] An acquisition of a block of business by indemnity or assumption reinsurance does not usually give rise to the reinsurer acquiring control of the ceding company, so no Form E "market share" filing should be required. However, if the acquiror is not comfortable with this approach, the acquiror should conduct the market share analysis to determine whether a Form E "market share" filing is required in any state in connection with the proposed transaction.

Third Party Administrator Licensing. If an acquiror acquires a block of life, health or annuity business by indemnity reinsurance and also desires to service the reinsured business, such as collecting premiums or adjusting and settling claims, then the acquiror must consider whether it needs to be licensed as a third party administrator in any state to perform the services.

The laws or regulations of many states regulate "administrators" or "third party administrators." Many states model their regulation of administrators on the NAIC Third Party Administrator Statute that

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[10] For an example, see Section 48.31B.020 of the Revised Code of Washington.

defines an administrator as "a person who directly or indirectly solicits or effects coverage of, underwrites, collects charges or premiums from, or adjusts or settles claims on residents of this state, or residents of another state from offices in this state, in connection with life or health coverage or annuities . . ."

A number of statutory exemptions in the NAIC Model Statute apply, including (i) "employer on behalf of its employees or the employees of one or more subsidiaries or affiliated corporations of such employer;" and (ii) "an insurer which is authorized to transact insurance in this state with respect to a policy lawfully issued and delivered in and pursuant to the laws of this state or another state."

All such states except Kentucky, Nevada and Texas appear to exclude from the definition of "administrator" an insurer licensed in the state. Thus, if the acquiror of a life, health or annuity block of business is licensed as an insurer in each state in which owners of reinsured policies reside, then the acquiror need not be licensed as an administrator in the state to provide administrative services for the policies it reinsures from the ceding insurer. In addition, even if an insurer is exempt from licensing as a third party administrator in Alaska, it must make a filing claiming the exemption.

Withdrawal Statutes; Cancellation/Nonrenewal Laws. If the ceding insurer is withdrawing from a line of business contemporaneously with the sale of a block of business to an acquiror by assumption reinsurance or indemnity reinsurance, then the seller must consider whether state laws or regulations in any state require prior notice to the state insurance regulator of that state of the withdrawal. These laws are designed to put the state insurance regulator on notice of an insurer withdrawing from a line of business so the state insurance regulator can be aware of any potential market disruption arising out of the withdrawal. While some of these laws and regulations apply to any line of business, many are focused on health insurance and property/casualty insurance.

In addition, if the business being exited from is property/casualty insurance, the impact of statutory cancellation/nonrenewal laws should be considered. These laws typically limit the ability of the insurer to cancel an insurance policy mid-term and require prior notice to the policyholder if the insurer does not intend to renew the policy.

(2) Transfer of U.K. Insurer's Obligations to Purchaser

A portfolio of insurance may effectively be sold by a U.K. insurer via a reinsurance arrangement akin to U.S. indemnity reinsurance, avoiding the time and expense involved in the process for transferring primary obligations to the purchaser. The acquiror (which must be, or have an affiliate which is, authorized to reinsure the type of insurance business being sold) may also purchase some or all of the Target's assets and may take on the Target's liability for running-off the existing portfolio.

However, as with U.S. indemnity bulk reinsurance, primary responsibility under the portfolio remains with the Target, which is then exposed to the credit risk of the reinsurer until all obligations under expired policies have been met. The Target will also retain primary responsibility, so far as the FSA is concerned, for the run-off of the existing business notwithstanding the agreement between the Target and the acquiror; indeed, the FSA is likely to need to approve in advance all arrangements made between the Target and the acquiror regarding the run-off, on the basis that it is a "material outsourcing" by the Target of its obligations to policyholders (see further discussion in section 5.b of Chapter Four).

For these reasons and, in particular, where a portfolio of life or long-tail business is to be acquired, a portfolio transfer under the statutory mechanism contained in Part VII of the Financial Services and Markets Act ("FSMA") may be preferred. The effect of this is to act as a kind of statutory novation whereby all outstanding obligations under the relevant block of business are transferred to the acquiror. The statutory transfer process may be used as part of a stock purchase transaction (to

move policies into or out of the Target) or as a "stand alone" acquisition mechanism.

Indeed, one of the advantages of the statutory scheme is that it may incorporate the transfer of other assets, rights, contracts and liabilities of the transferring insurer, in addition to the relevant policies, "… whether or not the transferor otherwise has the capacity to effect the transfer …." This means that the scheme can act as a kind of statutory asset acquisition mechanism where most or all of the transferring insurer's business is to be acquired and has the potential to include (for example) third-party reinsurance contracts protecting the transferred business without the need for express consent from the reinsurers concerned.

Since the statutory transfer process obviates the need for the seller and the acquiror to obtain the participation of individual policyholders in the novation process, it is understandably subject to a considerable degree of regulation, regardless of whether the business being transferred is general business, such as property/casualty, or life business. An application must be made to the U.K. courts for approval of the scheme. The court will require the production of an actuary's report on the proposed scheme and will have regard to any views expressed by policyholders or other interested parties. Although FSMA does not require the FSA formally to approve the transfer scheme, the FSA will have to confirm to the court that it is satisfied with the scheme before the court may sanction it. The FSA therefore needs to be consulted at an early stage: it will consider matters such as the security of policyholders' contractual interests, alternatives to the scheme and the opportunity which policyholders have had to consider the scheme (and, in this context, the FSA may direct the parties as to whether a policyholder circular or other forms of publicity for the scheme will be required).

Any transaction in which this type of portfolio transfer is to be an element will need to be structured around the need to obtain the court's prior approval. The parties should generally expect this to take approximately six months to obtain (though a shorter period may apply). This may mean requiring the court's approval to be obtained in

advance of closing or a requirement in the acquisition agreement for the parties to achieve the sanctioning of the transfer scheme as soon as possible post-closing.

A number of other European countries allow insurance portfolio transfers to take place without individual policyholder approval. Some impose lengthy periods for policyholder consultation, while others allow policyholders to cancel their policies on conclusion of the transfer. Some (notably the Netherlands) allow a certain percentage of policyholders to block transfer of life business altogether. These regulatory requirements may also have a consequential effect on structure and timing of the transaction.

(3) Renewal Rights Sales

As noted in Section 1.d of this Chapter, renewal rights sales may be used as an alternative to the outright acquisition of an existing portfolio of insurance policies. In that context, they avoid issues such as the validity of novations under assumption reinsurance and the potential delay and expense in obtaining court and other regulatory approvals for a portfolio transfer. They are also useful where the acquiror does not currently operate (and has no wish to acquire) the IT systems on which the existing business is processed: individual policy data can be input directly into the acquiror's existing systems as the policies come up for renewal.

However, renewal rights sales give rise to a number of potential issues which do not arise on a block transfer:

Customer ownership. Depending on how the Target came to acquire policyholders in the first place, it may be subject to contractual restrictions imposed by third parties on the use to which policyholder information is to be put and the entities to whom it may be disclosed. This may impact upon its ability to sell "right to renew" policies in the first place.

Consumer Privacy and Data Protection. In the U.S., NAIC model consumer privacy regulations contain an exemption from the notice and opt-out provisions which would otherwise apply, where the sharing is "in connection with a proposed or actual sale, merger, transfer or exchange of all or a portion of the business or operating unit" and where disclosure concerns solely consumers of the business or unit. However, a large number of states do deviate from these regulations and an acquiror will wish to ensure that no individual policyholder information is supplied as part of the due diligence process in breach of applicable state regulations. Data transfer on closing should come within the exception to the extent available.

Under U.K. data protection legislation, the transfer by the Target of individual policyholder details to the acquiror at the closing of a renewal rights transaction will constitute "processing" by each of them of that personal data, in the same way as arises in the context of disclosure for the purposes of due diligence. This is different from the position on closing of a stock purchase transaction, where the Target retains (and does not need to transfer) personal data to the acquiror. Unless policyholders have already consented to this, the processing is likely to be in breach of the legislation, in the absence of a suitable justification.

Although achieving the sale may be construed as being within the legitimate interests of the seller and thus satisfying one of the required conditions for "fair processing" of personal data, this "legitimate interest" exception will not assist where policyholder details consist of "sensitive" personal data, such as information about their medical history. In these circumstances, the seller and the acquiror will need to give careful consideration to the best method of obtaining policyholder's consent to the transfer of their data at closing.

Since the acquiror will, post-closing, be the new "controller" of personal data relating to policyholders, notice of this fact will need to be given to policyholders as part of "fair processing information." This is usually done by the acquiror but the seller will be concerned to ensure that the notice is given and in a form satisfactory to it. This often means agreeing to the form of notice in advance. Where sensitive personal

data are to be transferred on completion, the parties may need to use the fair processing information notice as a means of dealing with the "consent to processing" point.

Attrition. To the extent that policyholders have to take some positive steps to renew their policies with the acquiror, there is an increased risk that some may opt not to renew. This risk needs to be considered by the parties and factored into the transaction structure. It may be that all or some element of the consideration should be payable on an earn out basis, based on certain levels of retention of business over a given period, or a "commission" basis. If this approach to consideration is to be adopted, the parties should consider the taxation implications of this for each of them, as tax treatment of consideration on this basis may well differ from what it would have been, had the seller's business been sold as a going concern.

(4) 100% Reinsurance of Expired and In-Force Book

It is quite common for a "pure" renewal rights sale to be combined with a 100% reinsurance of the seller's expired and in force book. Although not a "sale" of these policies, the due diligence which the acquiror, as reinsurer, will wish to carry out on the portfolio to be reinsured will be substantially the same as on an outright acquisition. This is particularly the case where the "reinsurance premium" is based on the seller's current level of reserves in respect of the policies to be reinsured: the acquiror will wish to conduct the same type of due diligence on these reserves as it would if it were acquiring primary liabilities under the policies in a bulk reinsurance transaction (or acquiring the Target insurer's stock). If employees and other assets are being acquired to enable the acquiror to run-off the remaining risks, the acquiror will need to conduct due diligence on these too.

(5) Fronting

Whether an asset purchase is to be structured as a bulk reinsurance transaction, portfolio transfer or a renewal rights transaction, the parties may face the problem that the acquiring entity simply does not have the licenses or authorizations, or the approved policy forms, required to take on or renew the type of insurance business being acquired and stands little chance of obtaining it within the parties' desired timetable for closing. In these circumstances, the parties may agree that the seller will "front" renewals of existing business for the acquiror for a transitional period. This is generally achieved by having a 100% indemnity reinsurance agreement in place under which all business renewed post-closing is ceded by the "fronting" seller to the acquiror or an affiliate.

The seller will need to consider carefully the cost of continuing to provide regulatory capital to support the "fronted" renewals, so that this can be factored into the economics of the transaction. If the "fronted" renewal business is not to be transferred outright to the acquiror by means of an assumption reinsurance or a portfolio transfer at the end of the fronting period, the seller will need to consider its exposure to any credit risk presented by the acquiror's reinsurance.

Any U.K. insurer carrying out a fronting exercise of this kind in circumstances where all or most of the business assets have been sold to the acquiror at closing will also need to consider the potential for the acquiror's handling of the business to constitute a "material outsourcing" of the seller's obligations requiring, *inter alia*, prior approval from the FSA.

b. Associated Assets and Employees

An asset purchase is generally preferable to a stock purchase for an acquiror who wishes to pick and choose parts of the Target's business to be acquired. It is particularly favored where the acquiror wishes to acquire only a specific portfolio of insurance business to expand or

complement its existing operations. However, the acquiror will not always have the ability to leave behind in their entirety all other aspects of the seller's business.

(1) Reinsurance

In the sale of a block of in-force business, there may well be an issue as to the position of existing third-party reinsurance. In the U.K., the Part VII FSMA process for transferring a block or portfolio of insurance policies has the potential to transfer existing reinsurance to the acquiror at the same time without the reinsurer's express consent. Indeed, commutation or substitution of existing reinsurance on the portfolio might cause the FSA some concerns as to the future security of policyholders' interests. The general rule in the U.S. is that the acquiror takes the business net of existing third-party reinsurance; the existing third-party reinsurance continues to inure to the benefit of the seller although the seller and the acquiror may negotiate which party assumes the risk that a third-party reinsurer fails to pay or becomes insolvent.

In some cases, however, it may be in the parties' best interests to seek termination and commutation (for property/casualty reinsurance) or recapture (for life reinsurance) of existing reinsurance so as to permit the acquiror to take 100% of the risk of the in-force business that is the subject of the transaction. If that is to happen, it may be necessary to approach reinsurers for their approval to proposed arrangements at an early stage.

(2) Employees

It does not necessarily follow that, because the seller and the acquiror may have agreed between themselves that no employees are to be "sold" as part of the transaction, this will be the result. Legislation in the

U.K.[11] and in other EU countries protects the position of employees where stock in their employer is not being acquired but the "undertaking" in which they work is being sold instead: the key effect of this legislation is automatically to transfer the employer's obligations under the existing employment contracts of the affected employees to the acquiror by operation of law. (There are special rules relating to transfer of pension rights.) This means that, if those contracts are terminated by the acquiror post-closing to achieve the effect the parties intended, it is to the acquiror that the employees are entitled to look for compensation (for unfair dismissal or whatever other claims the applicable law allows). Any dismissal of employees for a reason connected with the transfer will automatically be unfair, unless the acquiror can show that it was for a genuine "economic, technical or organizational reason entailing changes in the workforce" and not simply because the parties wished to avoid the effect of TUPE. Any changes to employment contracts made by the acquiror by reason of the transfer will be unlawful even if employees consent to such changes, although there are possible solutions to this problem. The legislation imposes pre-transfer consultation obligations on the seller and the acquiror in relation to the affected employees and provides for an attendant financial penalty (of 13 weeks' actual pay per affected employee) for failure to consult, a liability for which the seller and the acquiror will be jointly and severally liable unless the parties agree otherwise in the transaction documents. The legislation also requires a seller to provide information about the transferring employees to the acquiror with a potential liability of not less than £500 per employee for failure to do so.

It is not always easy to determine whether an "undertaking" has been transferred — what constitutes the "stable economic entity" to which

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[11] The Transfer of Undertakings (Protection of Employment) Regulations 2006 or "TUPE" replaced the 1981 TUPE Regulations, which were introduced in the U.K. to implement the first EU Acquired Rights Directive.

TUPE applies? A key determinant may be whether the entity in question retains its identity after the transfer. The legislation and its substantial case law provides that the TUPE regulations can apply to transfer employees and protect employment rights in a number of different situations, not only in the context of asset/business sales, but also where services are outsourced, "insourced" or assigned by a client to a new contractor. The position is often complicated by the fact that some employees may carry out tasks partly in relation to the seller's retained business and partly in relation to the business being sold. There may even be a problem for the seller, if some employees who were intended to be retained, automatically transfer under TUPE into the employment of the acquiror.

The parties cannot exclude the operation of TUPE but they can seek to anticipate the consequences of its application and legislate for them in the transaction documents. This may take the form of the acquiror having the right to terminate the transferred contracts of "unwanted" employees post-closing and claiming an indemnity for the financial consequences of this from the seller in respect of at least some of the employees.

Private acquisitions of insurance companies are complicated, and require expertise in both M&A and insurance matters. This chapter only scratches the surface of many of the unique issues raised in these transactions, and for every statement made herein, there are likely to be variations or exceptions. Cross-border transactions add a further level of complexity, as there is a fair amount of "lore" and less "law" to the process.

CHAPTER THREE — PRIVATE EQUITY INVESTMENTS IN THE INSURANCE INDUSTRY

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This Chapter discusses the continuing growth of private equity investments in the insurance and insurance services industries and identifies a number of the key considerations that have historically arisen in the context of private equity acquisitions of insurers and insurance services providers in the U.S. and the U.K. While the regulated status of insurers and, indirectly, insurance holding companies, presents significant challenges to the traditional leveraged buyout model, private equity firms, as discussed in Sections 1 and 2 of this Chapter, have been increasingly successful at adapting their investment strategies to the insurance industry and its regulatory environment. Private equity firms have also successfully invested for many years in insurance services companies, as those companies can offer investments tied to the performance of particular insurers, or particular sectors of the insurance industry more generally, without presenting significant regulatory obstacles, such as restrictions on leverage. While the uncertain

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economic environment in recent years, coupled with the significant regulatory activity in response to the financial crisis, including the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), has created new challenges for private equity buyout activity generally, we believe the enduring and cyclical nature of the insurance and insurance services industries will continue to provide attractive investment opportunities for private equity firms.

1. GROWTH OF PRIVATE EQUITY ACTIVITY IN THE INSURANCE INDUSTRY

a. Steady Growth

Although comprehensive industry-wide data for private equity investments in insurance transactions is not available, our involvement in, and review of, relevant transactions suggests that the trend of steady growth that began in the early 1990s, with KKR's seminal $1.43 billion acquisition of control of American Re-Insurance Company, has now continued for two decades, with a broadening of both the number of private equity firms participating in the insurance sector and the types of investments being made.

Reflecting this growth, a significant number of private equity firms are now devoted exclusively, or at least primarily, to investments in financial services firms, including several funds with a principal focus on insurance investments. Among the leading funds in this category are the Trident funds managed by Stone Point Capital LLC, which together have raised $9 billion for financial services transactions; the J.C. Flowers funds, managed by J.C. Flowers & Co. LLC, which have raised over $11 billion for investment in financial services industry transactions; and Capital Z Financial Services Fund, which together with predecessor funds, has invested in excess of $2.5 billion in over 55 transactions since 1990. While many of the private equity transactions in the sector have historically been concentrated in these and other similar funds, private

equity participation in the insurance industry has now become much broader, with significant investments by various leading firms including The Blackstone Group, KKR, Cerberus Capital Management, Hellman & Friedman, J.P. Morgan Partners and Thomas H. Lee. In June 2007, the Carlyle Group, which has made substantial investments in insurance and insurance-related companies, including its investment in China Pacific Life and its 2006 acquisition of Multiplan, Inc., established a new financial institutions group to make investments in the insurance and banking fields.

These firms are investing in a diverse range of transactions, including minority investments in insurance companies in partnership with existing insurers, investments in insurance and reinsurance start-ups and outright acquisitions of control of established insurance companies, producers and other insurance services providers. While the financial crisis of 2008 predictably slowed the pace of M&A generally, and private equity buyouts in particular, as the economy continues to slowly recover, the private equity deal market has improved, albeit with some choppiness along the way. Mergermarket Limited's M&A Round-Up for H1 2012 indicates that the first half of 2012 saw $113.8 billion of private equity buyout activity across all industries, representing a decrease in activity compared to H1 2011 but an increase of approximately 35% from the H1 2010. Recent deals in the insurance space demonstrate the continued commitment of private equity sponsors to the insurance industry.

- **Investments in Insurance Companies**. Recent acquisitions of, or investments in, insurance companies by private equity firms include: the pending $1.1 billion investment by a private equity group led by Affinity Equity Partners in Korea's Kyobo Life Insurance Co, Ltd.; the recent acquisition by J.C. Flowers of Belgian insurer Fidea for €244 million; Cinven's acquisition of Dutch insurance group Aegon NV's U.K.-based Guardian life and pensions business for £275m; the acquisition by Athene Holding Ltd., a Bermuda company sponsored by affiliates of Apollo Global Management, of Liberty Life Insurance

Company, the U.S. life insurance business of RBC Insurance for $628.1 million; the acquisition of Pre-Paid Legal Services Inc., the parent company of Pre-Paid Legal Casualty Inc., by MidOcean Partners for approximately $650 million; Goldman Sachs's acquisition of a 12.02% interest in China-based insurer Taikang Life Insurance Co. Ltd. in a partial sale to a consortium of buyers totaling $1.2 billion; Vogo Investment's acquisition of a 44.0% stake in Tong Yang Life Insurance Co., Ltd. for approximately $793 million; Catalina Holdings' acquisition of Glacier Reinsurance AG, a Swiss-based reinsurance company in run-off, for a discount to net asset value of $374 million; and the 2010 acquisition of Amsterdam-based insurer Brit Insurance Holdings NV by Apollo Global Management and CVC Capital Partners Ltd. for approximately $1.56 billion. These acquisitions add to the long list of leading historical investments by private equity firms in insurance companies including: the 2007 acquisition of the publicly traded James River Group, Inc. by the D. E. Shaw group for $575 million; the $600 million equity co-investment in 2007 by Cerberus Capital Management and MassMutual in Scottish Re Group Limited, a global life reinsurance specialist; the $320 million tender offer in 2007 by Fortress Investment Group for Alea Group, a Bermuda insurance and reinsurance company listed on the London Stock Exchange; and the $200 million investment in 2008 by Pine Brook Capital Partners L.P., Soros Strategic Partners L.P. and others in Narragansett Bay Insurance Company, a specialty insurer. Private equity firms have also made minority investments in financial services companies through Private Investment in Public Equity transactions, or "PIPEs." A notable example of a PIPE transaction in the insurance sector is the 2008 $800 million investment by Warburg Pincus in MBIA Inc.

- **Investments in Producers**. Private equity investments have not been limited to insurers, but have also included insurance producers. Recent transactions involving insurance producers

include: New Mountain Capital LLC's agreement to partner with AmWINS Group, the specialty insurance broker, in a recapitalization valued at approximately $1.3 billion; the offer by TPG Capital and CDH Investments, in a consortium with the founder of CNinsure Inc., to acquire all of the outstanding shares of the China-based insurance intermediary company CNinsure Inc. for approximately $774 million; J.C. Flowers's acquisition of a controlling stake in loan insurance broker Compagnie Européenne de Prévoyance in a €830 million leveraged buyout; and Advent International Corp.'s £200 million investment in Towergate Partnership Ltd., a European independent insurance intermediary.

- **Investments in the Insurance Services Sector**. Private equity sponsors have also continued to invest in the insurance services sector, which has traditionally been much less regulated than insurance companies and insurance producers. Prominent examples include: Stone Point Capital's recently announced investment in Enstar Group Limited, a Bermuda-based insurance run-off services company, of approximately $100 million; the £1 billion acquisition by The Carlyle Group of the RAC roadside rescue business of UK insurer Aviva; the 2010 acquisition of Multiplan, Inc. by BC Partners Limited and Silver Lake Partners in a deal reportedly totaling approximately $3.1 billion; the 2010 acquisition by Stone Point Capital and Hellman & Friedman, together with management, of Sedgwick Claims Management Services, Inc. for approximately $1.1 billion; the 2009 acquisition by Cunningham Lindsey, a portfolio company of Stone Point Capital, of GAB Robins' international loss adjusting and claims management services businesses (excluding its U.K. operations) and its 2010 acquisition of GAB Robins' U.S. loss adjusting business. These acquisitions were preceded by a long history of deals in this space, including: the acquisition of the life, commercial and retirement services divisions of the BISYS Group, Inc. by J.C. Flowers for $715 million and the acquisition of Alliant Insurance Services, Inc. by

The Blackstone Group from Lindsay Goldberg for a reported $1.2 billion.

- **Sidecars and other Start-Ups**. Some of the most significant deals in recent years have taken the form of insurance and reinsurance start-ups capitalized by investor groups led by private equity firms. Private equity investors actively participated in the Bermuda start-ups that were formed following the events of September 11, 2001. These transactions included: Trident's founding of AXIS Specialty Ltd., a Bermuda specialty lines insurer and reinsurance company formed in late 2001 with $1.7 billion of capital provided by a number of private equity investors and Capital Z's formation in late 2001 of Endurance Specialty Insurance, Ltd., another Bermuda-based specialty lines insurer and reinsurer, with over $1 billion from investors including Capital Z. The successor holding companies of AXIS Specialty and Endurance Specialty each completed initial public offerings in 2003. Following the hurricanes of 2005, similar activity was seen in this area, including: the 2005 Bermuda-based start-ups of Flagstone Reinsurance Holdings Ltd., Lancashire Insurance Company, Validus Reinsurance Ltd., Ariel Reinsurance Ltd. and others, which reportedly raised approximately $7.5 billion in initial capital on a combined basis, largely from private equity and hedge funds; and in Europe, the investment by Soros Fund Management and others in Glacier Re, the reinsurer formed in January, 2005. More recently, Stone Point Capital teamed up with Alterra Capital Holdings Ltd. and a syndicate of other investors to establish New Point IV, a market facing side car affiliated with Alterra Agency Limited, with up to $200 million in capital to provide property catastrophe reinsurance capacity in the wake of the recent string of catastrophe losses. Last year's catastrophic events in Japan have renewed interest in reinsurance sidecars.

Private equity firm start-ups have primarily been in non-life

insurance businesses, with some concentration in the property/casualty and reinsurance sectors. However, private equity firms have also made investments on the life insurance side, for example: Trident's 2005 funding of Wilton Re, a life reinsurance company, with over $1 billion of committed capital from investors, including several other prominent private equity firms.

Other examples of start-up activity include the July 2009 launch of InSphere Insurance Solutions, an insurance agency, by affiliates of The Blackstone Group, Goldman Sachs Capital Partners and Credit Suisse; the August 2007 formation of SPARTA Insurance Holdings, Inc. by a group of private equity investors led by Corsair Capital LLC and First Reserve's 2008 formation of (i) Sideris Re, an energy insurance joint venture between First Reserve Corporation and C.V. Starr & Co. and (ii) Torus Insurance Holdings Limited (Bermuda), a provider of specialist insurance solutions with a focus on the energy sector.

- **Investments in Lloyd's**. A feature of private equity investment in Europe has been its interest in the Lloyd's market; this has taken the form of investment in Lloyd's entities (or their parent companies) either directly or by investment in Bermuda companies which in turn have Lloyd's interests. Lloyd's operations started by private equity sponsors in recent years include new Syndicates 2243 and 5678. The Bermuda-based start-ups have now reached the stage of development where they themselves are acquiring Lloyd's entities in deals such as the Validus acquisition of Talbot Group in July 2007 and Ariel Holdings Ltd.'s acquisition of Atrium Underwriting Ltd. in October 2007. Recently, Capital Z Partners and Terra Firma Investments were involved in a potential bid for Lloyd's insurer and reinsurer Chaucer Holdings Plc, which in 2011 was acquired by Hanover Insurance Group Inc.

- **Emerging Trends**. While not the subject of this Chapter, an important developing trend in the insurance M&A market is the entry of alternative asset managers, such as hedge funds, who view the formation or acquisition of an insurance company as a potential way to lock-up the assets comprising the reserves of the insurance company for the long term, which can then be actively managed by the hedge fund using its investment expertise. Insurance company assets are particularly attractive for asset managers since, unlike capital provided by investors, insurance reserve assets are not subject to potential periodic withdrawals. Recent examples of transactions of this type include: the acquisition by Guggenheim Partners, LLC of EquiTrust Life Insurance Company, a life and annuities subsidiary of FBL Financial Group, Inc., for $440 million; the acquisition by Athene Holding Ltd., a Bermuda company sponsored by affiliates of Apollo Global Management, of Presidential Life Corp. for about $415 million; the formation of reinsurers by Third Point LLC and SAC Capital Advisors LP; and Harbinger Group Inc.'s acquisition of Old Mutual plc's U.S. life and annuities division for $350 million. It will be interesting to see how this trend develops over the coming years.

b. Principal Drivers of Growth

A number of factors have attracted private equity firms to participate in the ongoing consolidation in the insurance industry. These include:

- Opportunities for smaller, focused management teams to meet consumer demand for better service, expanded and more cost-effective product offerings and new methods of distribution.
- Decreased risk profile among larger insurers and consolidators that has created niche market demand for certain insurance products that can be supplied by smaller, focused organizations.

- Demutualization, consolidation and privatization among established insurance companies in the U.S. and abroad.
- Perception that there are under-managed assets in the industry.
- Potential for unlocking value based on increasing insurance investment portfolio yields.
- The cyclical nature of the insurance business, which provides opportunities for high rates of return if investments are properly timed. (Of course, this factor can also cut the other way — if a private equity fund's business plan requires it to exit an insurance business during a disadvantageous point in the cycle, returns would be depressed.)
- Opportunities arising out of divestitures by insurers re-focusing on core lines of business (such as certain recent divestitures by ING, Hartford and HSBC).

Most insurance industry private equity funds have a professional staff with many years experience in the insurance industry and mergers and acquisitions. These firms' competitive advantage is their familiarity with the complexity of the insurance business and the significant regulatory hurdles for transactions in this sector, their appreciation of the unique opportunities in this sector and their deep and diverse relationships with leading figures in the industry. This expertise is likely to be even more valuable as the regulation of the insurance industry evolves in the wake of the financial crisis. As noted below, financial sponsor firms also provide an alternative source of capital that can permit existing management to retain significant operational control over the business in which the investment is being made.

2. CHALLENGES OF APPLYING TRADITIONAL LEVERAGED BUYOUT MODEL TO INSURANCE COMPANY INVESTMENTS

a. Traditional Leveraged Buyout Model

The leveraged buyout model has traditionally sought to generate private equity returns (25-35%) on the basis of a leverage target of at least 3-4:1 and repayment of debt from target cash flow over a four to seven year period.

- Debt in the leveraged buyout capital structure typically consists of a combination of senior bank debt and subordinated high yield debt, mezzanine debt or similar securities.
- Senior bank debt is typically loaned to or assumed by the target operating company and the bank is typically granted a security interest in all of the assets of the target; the holding company of that target typically guarantees this debt and pledges all of target's stock to the bank.
- High yield debt is also frequently issued by the target operating company, typically on a senior subordinated, unsecured basis.
- Interest and principal payments on the senior bank and subordinated high yield debt are funded out of target's operating cash flow.

b. Structuring Leverage in Insurance Acquisitions in the United States

A variety of regulatory impediments have historically required that leveraged buyouts of insurance companies in the U.S. be financed with substantially less leverage than those in other industries and that the leverage be placed at the level of the holding company that acquires the

insurer, not at the insurance company level. Thus, both structurally and legally, policy claims rank senior to lenders' claims, in the event of receivership of the insurer (a proceeding that is governed by the law of the insurer's state of domicile, as an insurer cannot be a debtor under the federal Bankruptcy Code). These constraints are intended by regulators to assure that a healthy insurer remains healthy even if the holding company encounters difficulty servicing its debt.

(1) Restrictions on Debt Placed Directly on the Insurance Company

Insurance regulators may prohibit debt from being placed directly on the insurance company, even on an unsecured basis, unless the loan proceeds are received by the insurer. This would preclude an LBO target from issuing or assuming any acquisition-related debt since the proceeds of that debt are typically used to fund the purchase price for the acquisition and hence "received" by the seller, not the insurer.

Insurance laws may also restrict pledges of the assets of the operating insurance company. For example, New York domestic insurers may not, without prior regulatory approval, pledge more than 5% of their admitted assets. Other states may prohibit pledging assets to secure another person's debt or guaranty or have limits on pledging assets to assure that there are sufficient unencumbered assets to pay policyholder liabilities.

(2) Restrictions on Holding Company Debt

Accordingly, in leveraged buyouts of insurers, debt is typically placed at the holding company level. As in conventional leveraged buyouts, insurance leveraged buyouts are typically funded by a combination of senior bank and junior high yield debt, albeit on this structurally subordinated basis.

Senior lenders such as banks lend to the holding company that is purchasing the insurer and may receive a pledge of the insurance company's stock, the holding company's principal asset. But unlike most conventional leveraged buyouts, foreclosure on the pledge would be conditioned on insurance department approval of the acquisition of control of the insurer by the purchaser at the foreclosure sale.

Because it is at the holding company level, all of the debt is structurally subordinated to the claims of all claimants against the insurer, including policyholders.

Nonetheless, insurance regulators' concerns about protecting policyholder interests may even significantly limit the amount of leverage that may be placed at this holding company level. At the time the holding company acquiror seeks approval to acquire control of the insurer, the regulator may limit the amount of debt that may be placed on the acquiror — debt that would be serviced largely from cash flow from the insurer. California, for example, has for many years published guidelines for leverage of insurance holding companies which, among other things, require that the insurance holding company maintain a positive tangible net worth, and require a ratio of debt to consolidated equity of no more than:

> 1.0 to 1.0 in the case of a 5 year loan;
>
> 1.5 to 1.0 in the case of a 10 year loan; and
>
> 2.0 to 1.0 in the case of a 20 year loan.

Furthermore, financial strength ratings of an insurer, crucial in most insurance markets as a commercial matter, may be adversely affected by high leverage at its holding company level.

Even though these factors have tended to result in insurance deals being less leveraged than conventional LBO deals, paradoxically, they also have generally resulted in higher financing costs than in conventional leveraged buyouts. This incremental cost appears to be attributable in part to the smaller pool of bond investors in the market for these

transactions and an increased perception of risk. It remains to be seen whether these dynamics will continue.

(3) Insurance Company Dividend Restrictions

Because the debt is at the holding company level, insurance company dividend restrictions create additional issues for servicing debt.

Typically, an insurer may not pay any dividend other than from "earned surplus." This usually equates with "Unassigned Funds (Surplus)" as reported on the insurer's statutory financial statement. An insurer with a prior history of losses may have a negative "earned surplus," which may be a barrier to payment of any dividend (or, in some states, require a prior domestic state insurance regulatory approval).

Typically, an insurer may not make an "extraordinary dividend" without the prior approval of the domestic state insurance regulator. An "extraordinary dividend" is usually defined to mean a dividend or distribution of cash or other property whose fair market value, together with other dividends and distributions made within the last 12 months, exceeds the greater of: (i) 10% of the insurer's policyholders' surplus as of the preceding December 31, and (ii) the net income of the insurer for the 12-month period ending the preceding December 31, all determined in accordance with statutory accounting practices.

(4) Tax Sharing Agreements

In addition to servicing debt through dividend payments, tax sharing agreements can also provide a basis for providing the holding company with funds to service debt.

Under a tax sharing arrangement, an insurer that is included in a consolidated tax return with the holding company (and possibly other affiliated companies) can make payments based on its share of the group's tax liability. In any one year, these payments can actually be more than the amount the group is required to pay to the taxing

authority. If, for example, taxable income generated by the insurance company is sheltered in the consolidated return by deductions generated by other group members, and the tax sharing arrangement is structured so that the insurance company pays in any given year what it would have paid if it had filed on a separate return basis, the tax sharing arrangement will provide net positive cash flow to the holding company in that year.

Note that a tax allocation agreement would typically be subject to review by the insurer's domestic state insurance regulator under state insurance holding company regulations as a transaction between affiliates in a holding company system, and the regulator could impose requirements that limit the effectiveness of the tax allocation agreement as a basis for servicing debt. New York, for example, has guidelines for tax allocation agreements that essentially require that any tax charge to the domestic insurer be no greater than it would have paid if it had filed on a separate return basis and that payments to the domestic insurer give appropriate recognition to the separate operating identity of the insurer.

(5) Administrative Services Agreements

It may also be possible to move money up to the holding company so as to facilitate debt service through administrative services agreements.

However, like tax allocation agreements and other transactions between affiliates in a holding company system, administrative services agreements between an insurer and its holding company parent are usually subject to review by the insurer's domestic state insurance regulator under state insurance holding company laws, and the regulator could impose restrictions on the cash flows under such an agreement limiting its effectiveness as a means of servicing debt.

New York, for example, limits the amount of money that may be upstreamed through an administrative services agreement by typically requiring that services provided by a parent or affiliate be provided at cost. Other states may be more flexible, for example, by allowing

services to be provided at arm's-length market prices (including a profit component).

c. Considerations in Europe

The regulatory difficulties described above are not shared universally in the European Union, although regulators are taking a keen interest in administrative services agreements to ensure that regulated entities have access to suitable and sufficient resources to enable them to perform their authorized functions and to comply with regulatory business conduct requirements and prudential supervision requirements.

Although regulation of insurance in the EU is based on a common regulatory platform through key Insurance Directives,[2] each member state has considerable independent authority as regards financial requirements imposed on insurers operating in its jurisdiction, and to that end potential investors in a multi-jurisdictional insurance entity within the EU would have to consider not only authorization and control issues (see Section 6 below), but also any applicable financial conditions which are either existing or may be imposed by regulators as a condition of granting any requisite consent to the private equity investment (for example, restrictions on payment of dividends or reporting requirements so as to enable the regulator to be satisfied as to ongoing solvency of the regulated insurance entity).

3. ALTERNATIVES TO TRADITIONAL LEVERAGED BUYOUT MODEL IN INSURANCE COMPANY INVESTING

For the reasons described above, leverage has not played as large a role in providing investment returns in insurance company leveraged

[2] Including the forthcoming Solvency II Directive which is due to come into force across the EU in 2014.

buyouts as it does in other industries. Financial sponsors therefore have devised alternative investment structures to generate leveraged buyout returns.

a. Minority Investing

A common form of private equity investment in insurance transactions is a minority investment, usually in partnership with a strategic buyer. The strategic buyer may be a foreign firm that is relying on the private equity firm for more in-depth knowledge of the particular insurance products in the target company's sector and for the firm's financial expertise, knowledge of U.S. compensation and benefit programs and understanding of U.S. market culture and regulatory requirements.

In some instances, financial sponsors have made investments in insurance companies by purchasing a minority ownership stake directly from the insurer's owner, who then retains the balance of the equity. This may enable the insurer's owner to reduce its exposure to the target insurer while at the same time allowing it to benefit from the public market validation associated with a private equity investment in the insurer. It can also provide a mechanism to strengthen the management team's commitment to the insurer.

Indeed, to create a private equity-like culture at a target insurer, financial sponsors typically insist that minority investments of this kind be coupled with a restructuring of management's compensation arrangements to align management's interests with the equity holders and otherwise ensure that management has the requisite "skin in the game" for a private equity investment.

To enhance the return of the private equity firm's investment, a minority equity stake may come with warrants. To ensure a minimum return, investments frequently take the form of convertible debentures or convertible preferred stock, with or without common stock investments.

Along these lines, one type of minority investment in the financial services industry, including the insurance sector, that has been seen

more often since 2008 is PIPE transactions. Indeed, during the financial crisis, a number of publicly-traded financial services companies turned to private equity and hedge funds to recapitalize their balance sheets. And, with the unavailability of financing to execute leveraged buyouts, private equity firms found minority investments of this kind to be an attractive means of deploying capital. The economics of these PIPE transactions vary. Some take the form of common stock while others are convertible preferred stock investments (with varying provisions as to dividends). An equity kicker in the form of warrants (exercisable at a premium to the current market price) is fairly common, as are price protection mechanics that provide the private equity investor with a "make-whole payment" if there is a subsequent issuance of equity at a lower price. Beyond the economics of the investment, private equity investors typically negotiate for certain additional rights in connection with the PIPE transaction including the right to designate one or more directors, registration rights for the purchased securities, indemnity protection for breaches of representations and warranties and reimbursement of expenses.

b. "Leveraged Build-ups"

Leveraged build-ups involve an initial investment in a platform insurance or insurance services company which subsequently engages in acquisitions of other insurers or insurance services companies. Investment returns are generated by synergies and operating efficiencies achieved in connection with such acquisitions. This form of investment strategy is similar to that employed by strategic consolidators in the early days of their acquisitions and is now being employed by private equity firms that initially invest in a platform company. In such cases, the follow-on acquisitions may be financed with additional equity from the private equity firm, stock in the platform company, debt, including seller paper, or some combination of all three.

c. Start-ups and "Sidecars"

An important investment strategy employed by private equity investors in recent years is the formation and funding of insurance start-ups in Bermuda and other jurisdictions. Unburdened by legacy liabilities, these start-ups have generally been formed to take advantage of capacity shortfalls and favorable pricing in reinsurance and certain specialty insurance lines following the dislocation caused by catastrophic events, like the September 11 terrorist attacks and the devastating 2005 Atlantic hurricane season. These transactions include the 2001 start-ups of AXIS Specialty Ltd. and Endurance Specialty Insurance, Ltd., and the 2005 start-ups discussed in Section 1.a. of this Chapter.

An even more recent innovative investment strategy is represented by "sidecar" transactions that have been used to finance reinsurance for hurricanes and other risks. In these transactions, private equity investors typically capitalize a reinsurance sidecar – a special purpose insurer of limited duration formed to reinsure risks underwritten by a single reinsurer. The sidecar typically has none of the infrastructure normally associated with an insurance company (including employees), and instead relies on its reinsurance partner for marketing, underwriting and claims management purposes and on a third-party management company (or its reinsurance partner) for other aspects of its operations.

The industry-wide reassessment of catastrophe risk models following the record hurricane-related losses in the last decade has contributed to the development of the sidecar market, as many insurance companies have had to limit wind and other high severity exposures on their books in order to maintain their financial strength ratings. Such insurers have become receptive to sidecars, as a properly structured sidecar allows insurers to underwrite a higher volume of volatile business through the use of the sidecar without an adverse ratings impact to the existing insurance company, while sharing in positive underwriting results in the sidecar through the payment of a performance-based underwriting fee or an equity stake in the sidecar held by the insurer.

Private equity investors typically commit their capital to a sidecar for one or two year periods on the expectation that returns will be dependent entirely on the underwriting performance (and, to a significantly lesser extent, investment performance) of the sidecar during the underwriting period. This is in contrast to an investment in a traditional insurance start-up, where underwriting performance is an important factor in determining investment return, but the price/earnings multiple on an initial public offering or sale of the company is the most significant driver of investment performance.

d. Investment Arbitrage Opportunities

Another alternate investment strategy used by private equity firms seeks to capitalize on under-managed assets and inefficient claims management by selected insurance companies. In these transactions, the private equity sponsor typically purchases an insurer that is in "run-off," that is, no longer issuing new policies.

This type of transaction is typically structured as an acquisition by the private equity sponsor of the stock of the company in "run-off." Simultaneously with the acquisition, the target typically utilizes a portion of its surplus to purchase a reinsurance cover from the "ground up," which has the effect of augmenting the assets available to the target to meet its liabilities, thereby enhancing the appeal of the transaction to a regulator. The acquiring company then attempts to generate a private-equity level return by more actively and aggressively managing the target company's cost structure, including its claims related expenditures, and investment portfolio, subject, however, to applicable regulatory constraints.

To grant their approval to these type of deals, some state regulators may require a stronger showing that the liabilities of a target company in "run-off" will be adequately provided for. Others may have an informal policy prohibiting the sale of a company in run-off. Some state regulators may also be reluctant to approve the sale of a company in "run-off" to a financial buyer on the theory that a financial owner,

unlike a strategic owner, may have less commercial incentive to financially support the target should it encounter financial difficulties in the future.

In the years prior to the financial crisis, sales of companies in run-off to financial buyers and run-off management specialists became increasingly more common. Such deals have been as large as the 2006 acquisition of three of the ACE INA Group's Brandywine run-off reinsurance companies by Randall & Quilter Investment Holdings in a transaction involving approximately $1.1 billion in run-off liabilities.

e. Investments in Insurance Services Companies

As noted above in Section 1 of this Chapter, private equity funds are also investing in unregulated or less heavily regulated portions of the insurance sector that permit a more conventional leveraged buyout structure. Many recent opportunities for private equity investments in the insurance industry involve brokers and insurance service providers rather than insurance companies. Recent examples of buyout firm investments in related industries include the 2009 acquisition by Cunningham Lindsey, a portfolio company of Stone Point Capital, of GAB Robins' international loss adjusting and claims management services businesses (excluding its U.K. operations) and its 2010 acquisition of GAB Robins' U.S. loss adjusting business; the 2010 acquisition by Stone Point Capital LLC and Hellman & Friedman LLC, together with management, of Sedgwick Claims Management Services, Inc.; and the 2011 acquisition by the Carlyle Group of RAC roadside rescue business from U.K. insurer Aviva.

f. Reinsurance and Securitization

An alternative to debt at the acquired insurance company level is the use of reinsurance or securitization of policy obligations. By reinsuring a portion of a target insurance company's portfolio or setting up a special purpose vehicle to issue securities backed by the portfolio, an acquirer

can use less of its own capital to finance an insurance company acquisition without incurring debt on the insurance company's balance sheet that may run afoul of regulatory constraints. Securitization is more common in life insurance or related sectors than in the property and casualty space due to the more predictable nature of premium and claim flows in the life sector. Attempting to structure property and casualty reinsurance in a manner that would yield predictable economic flows might run the risk of the reinsurance being labeled finite by regulators.

4. COMPETING WITH STRATEGIC BUYERS

Historically, strategic buyers have had a number of advantages over private equity funds when competing to acquire insurance and insurance services companies. These include the following:

- Strategic buyers can sometimes achieve operating synergies that may allow them to pay more than a financial buyer.
- Public company strategic buyers can, subject to some limitations, use their stock as acquisition currency which, in a "bullish" stock market, may give them a bidding advantage over an all cash financial buyer.
- Strategic buyers with committed credit lines, significant internal cash or stock to use as currency also offer a seller greater closing certainty than a financial buyer whose obligations to consummate the transaction may be subject to a financing condition, or even absent such a condition, the ability to pay a finite "reverse termination fee" to the seller as the exclusive monetary remedy if the financial buyer is unable to obtain financing even absent any financing condition.
- Insurance company strategic buyers generally are at an advantage in obtaining insurance regulatory approvals because they are a known quantity to insurance regulators, although some financial buyers have, over time, established their

credibility and expertise with regulators. As noted above, insurance regulators generally believe that strategic buyers are more likely to support a troubled insurer financially, even if they have no legal obligation to do so, in order to avoid any collateral commercial damage to the strategic buyer's brand.

On the other hand, financial sponsors also have had some advantages over strategic buyers when competing to acquire companies. These include the following:

- Generally, the ability to retain a target's existing management team through the creation of an attractive package of equity incentives. See Section 5 of this Chapter.
- The ability to further incentivize management by combining the opportunity to participate in the equity of the LBO transaction with the relative independence of management permitted by the financial sponsor as to day-to-day operating decisions. See Section 5 of this Chapter.
- These advantages as to so-called "social issues" may allow a financial sponsor to retain target management for the long run, thereby increasing the value of the target insurer.
- Financial sponsor investments in this sector may also give an insurer's owner, through its retained equity position in the target, the opportunity to "piggy-back" on the private equity-like returns often produced by financial sponsors.

Financial sponsors have also had an advantage where companies are looking for additional capital in the form of a minority investment with specified management rights rather than a control acquisition. Such companies may be reluctant to seek a capital infusion from a competitor.

5. MANAGEMENT ARRANGEMENTS IN FINANCIAL SPONSOR TRANSACTIONS

a. Management Participation

Financial sponsors generally require management participation in leveraged buyouts in order to fully align management's interests with those of other equity holders and as a means of incentivizing management. Typically, financial sponsors offer management:

- The opportunity to buy (or roll over) stock.
- The opportunity to receive an award of options, restricted stock or other equity-based instruments or an award of phantom equity.
- The opportunity to roll over deferred compensation into equity on a tax-deferred basis.

The ability of a financial sponsor to structure management arrangements has been significantly impacted by Section 409A of the Internal Revenue Code, which imposes strict requirements on many types of compensation arrangements and imposes harsh taxes on the manager for noncompliance. Similar limitations are imposed under Section 457A of the Internal Revenue Code with respect to entities organized in "tax haven" jurisdictions and partnerships (including LLCs that are treated as partnerships in the U.S.), regardless of where organized, unless substantially all of the income of the financial sponsor investing in such partnership is allocated to persons other than (A) foreign persons not subject to a comprehensive foreign income tax and (B) tax exempt organizations. Financial sponsors need to be careful to construct management arrangements in a way that comply with, or avoid the application of, Sections 409A and 457A. Financial sponsors also need to verify that any sales or awards of equity to management comply with, or qualify for one of several possible exemptions from, federal and state securities laws.

b. Customization

The equity participation programs among traditional buyout firms share many common features, but each deal varies based on circumstances surrounding the deal. The scope of management participation varies, but is usually within a band of 5-15% of equity.

Depth of management participation depends on the financial sponsor's philosophy, the type of business, whether the target is public or private, and the culture of the business. The size of the equity pool and the wealth of the management team also help determine the extent of management participation.

Historically, financial sponsors have helped managers finance investments in the target's equity by using their muscle with lenders to obtain loans for management on favorable terms or permitting the portfolio company to provide guarantees or make loans directly. But there may be insurance regulatory limits or prohibitions on the insurer making loans or guaranteeing loans made to directors or officers. These insurance regulatory barriers may, in certain circumstances, be avoided by the holding company making the loan or guarantee. For example, New York:

- Prohibits any authorized insurer from making any loan to any of its directors or officers, directly or indirectly, or through its subsidiaries and any director or officer from accepting any such loan directly or indirectly (subject to limited exceptions).[3]
- Prohibits any authorized insurer or any of its affiliates or subsidiaries from directly or indirectly guaranteeing the financial obligation of any director or officer of the insurer, affiliate or subsidiary, and any such guaranty will be void.[4]

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[3] N.Y. Ins. Law § 1411(f)(1).

[4] N.Y. Ins. Law § 1411(g).

In addition, if the target or the holding company is or becomes public in the United States, the Sarbanes-Oxley Act of 2002 prohibits the provision of loans or other extensions of credit to target's executive officers (as defined under the federal securities laws). Therefore, company loans provided to managers of private companies would be required to be repaid prior to the company's filing of a registration statement under the Securities Act of 1933.

In addition to these regulatory and securities law issues raised by providing loans to management, particular care needs to be taken in making loans to employees in non-U.S. jurisdictions or by companies in non-U.S. jurisdictions, due to the possibility of tax and other regulatory concerns.

c. Management Stock, Calls and Puts

Most stock purchased by management is fully "vested" when purchased. The management's stock is, however, typically subject to a call by the company (or the financial sponsor) if the employee's employment is terminated for any reason prior to an IPO. The repurchase price is generally fair market value at the time of termination, but will often be the lesser of cost or fair market value if the employee is terminated for "cause" or quits without "good reason." In addition, some sponsors base the repurchase price on the time elapsed since closing, in effect creating a vesting schedule. Most calls expire upon an IPO.

Some sponsors permit stock to be "put" back to the company in limited circumstances such as the employee's death, disability, or retirement at normal retirement age, or, in some cases, termination of the employee without cause or by the employee for "good reason." If the portfolio company has public debt, stockholders' equity attributable to stock held by management stockholders and subject to a put (even if under limited circumstances, such as death or disability) is required under SEC rules to be treated as redeemable common stock and carried above the stockholders' equity line. Bank agreements and indentures typically limit the amount that a company can spend, either in any one fiscal year or in

the aggregate to repurchase stock from management. Financial sponsors are, therefore, wary of giving puts to senior management stockholders for their entire holdings, although this risk can be mitigated by providing that the target's obligation to fund on the put is suspended until an exit event or a refinancing of the bank agreement or indenture giving rise to such limitation or via the issuance of subordinated debt in consideration for the stock. In addition, repurchases can result in large earnings charges that may need to be carved out of debt covenants in advance. Puts generally also expire upon an IPO.

Stock purchased upon the exercise of management stock options also can become subject to these put/call rights. However, these rights are generally structured so as to trigger only after the employee has held the stock acquired upon the exercise of the options for at least six months. This holding period is imposed to avoid "variable accounting treatment," which would result in recurring compensation expenses to the company in an amount equal to the "spread," from time to time, between the fair value of the company's stock and the option's exercise price.

Stock or other equity-based instruments awarded to management are typically subject to vesting requirements, generally based on continued service to the company and/or the achievement of certain individual or company-wide performance goals or the attainment of certain rates of return to the financial sponsor upon an exit event. The nature of the vesting schedule is shaped by the financial sponsor's retention and incentive goals and its customary practices and negotiations with a target's management team. Stock received upon vesting or exercise is usually subject to the same puts and calls described above.

d. Drag-along, Tag-along and Participation Rights

The financial sponsor typically has the right to drag along management stockholders in the event of a private sale to a third party prior to an IPO. Management stockholders generally have the right to join the financial sponsors, or "tag along," in any sale of a significant portion of

its stock prior to an IPO. The financial sponsor may also provide management investors and other equity partners who are "accredited investors" under the securities laws the right to participate in any subsequent purchases of stock in the target company by the private equity fund or other third-parties, which provides a limited form of preemptive right.

e. Insurance Regulatory Constraints

Management equity arrangements may be subject to insurance regulatory constraints.

For example, New York domestic insurers may adopt a stock option plan for the benefit of their officers and employees. Any plan is subject to certain constraints including (i) the option price must not be less than 85% of the fair market value of the underlying shares on the grant date and (ii) options may not be exercised after 10 years from the grant date.[5] (The first of these requirements is no longer of great relevance as almost all options are structured to be exempt from Section 409A of the Internal Revenue Code and therefore have an option price of not less than 100% of the fair market value of the underlying shares on the grant date.)

Management seldom receives options to acquire stock of the insurer itself. New York restrictions may be avoided by offering holding company stock options. New York regulation of insurance holding company stock options was repealed in 1996, but the New York Insurance Department noted in the repealer that New York holding company regulation of affiliate transactions "may be applicable in certain circumstances."[6]

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[5] N.Y. Ins. Law § 1207.

[6] *N.Y. St. Reg.*, July 24, 1996, at 13.

f. European Issues

The issues described above regarding management arrangements in U.S. transactions are common to transactions in the EU, subject to applicable tax requirements being different from the U.S. (and different as between EU member states).

There are, however, some additional issues to consider when structuring a package for management in an EU transaction:

- The applicable regulatory regime will likely require that the performance of "controlled functions" be conducted by "approved persons," thus necessitating that management remain in control of the day-to-day conduct of the insurance business of the regulated entity.
- If the projected exit for a private equity investor is through an IPO, it will be desirable for only one class of stock to be listed, with the result that any special shares or options granted to management in the pre-IPO period will have to be collapsed, converted or rolled over at the time of the IPO into one class of common stock to be listed. Similarly, this may be required for a U.S. company.
- In the post-IPO environment, while it will be usual (and in some jurisdictions a requirement under stock exchange listing rules) for management to be subject to "lock-ups" to prevent their disposal of stock and retain their continued involvement in the business, such lock-ups tend to be for no longer than a twelve-month period (or if longer, such lock-ups allow disposals by management on a year-by-year basis).
- Where the private equity investment is intended to take control of a publicly traded entity, management's participation in the transaction (and management's duty to comply with its fiduciary duties during the course of the transaction) will be governed by regulations that are different in each member state, and, in the case of the U.K., will be subject to the requirements of the City

Code on Takeovers and Mergers (the "City Code") under which the Panel on Takeovers and Mergers, an independent body whose main functions are to issue and administer the City Code, will not only have authority over the conduct and timing of the transaction, but also may require any package made available to ongoing management to be approved by shareholders of the target or be the subject of a fairness opinion from target's financial advisers.

6. REGULATORY APPROVALS FOR CHANGE OF CONTROL TRANSACTIONS

a. U.S. Deals

Acquisition of "control" of an insurer currently requires the prior approval of the domestic state insurance regulator of the target insurer and the state insurance regulator of any state in which the insurer is "commercially domiciled." "Control" is usually defined as the possession, directly or indirectly, of the power to direct or cause the direction of management and policies, whether through the ownership of voting securities, by contract, other than a commercial contract for goods or non-management services, or otherwise. Control is usually presumed if any person, directly or indirectly owns, controls, holds with the power to vote or holds proxies representing 10% or more of the voting securities of a person.

The application for approval of acquisition of control is usually submitted on a form called a "Form A." The Form A requires disclosure of the buyer and all of its controlling persons, directors and executive officers, financial statements of the buyer and its controlling persons and a description of the buyer's plans for the acquired insurer, including, in many states, detailed financial projections. If controlling persons include individuals, personal financial statements may be required. This can sometimes be problematic for the individual general partners of a private equity sponsor, who may have an understandable

aversion to filing personal financial statements with a regulator. Some regulators have been willing to accept "net worth" affidavits in these circumstances, in lieu of personal financial statements. In addition, some states require that directors and executive officers of the buyer and its controlling persons submit biographical affidavits and fingerprints. Confidential treatment for non-public information provided during the Form A process is typically available upon application to the insurance department, although the scope of protection from public disclosure varies from state to state and can be narrowly construed.

The following is a summary of the key regulatory issues in seeking approval for leveraged buyouts:

- **Amount of Leverage.** See Section 2 of this Chapter.
- **Possible Lack of Insurance Expertise of Financial Sponsor.** A financial sponsor can enhance the prospects of approval by securing services of experienced insurance professionals as directors and officers of the insurance company.
- **Transactions with Affiliates.** Most state insurance laws require that all material transactions between the insurance company and its affiliates be properly notified to the insurance department and require prior approval. Private equity firms often have management consulting indemnification and other agreements with the holding company which would not need to be filed with the regulator because the insurance company is not a party; however, the insurance operating company's ability to make dividend payments to the holding company to meet the parent's obligations under such agreements will be subject to the dividend restrictions discussed in Section 2.b(3) of this Chapter.

b. European Deals

For private equity investment in insurance entities within the EU, there is a mixture of EU and national "change of control" criteria that an

investment of even less than 10% in the share capital of a regulated insurance entity (or its parent) may trigger.

Based on the EU Acquisitions Directive which all EU member states were required to adopt before March 21, 2009, the basic EU member state framework on change of control provides that a person who (i) acquires or holds shares (unlike in the U.S., they need not be voting shares) that represent 10% or more of the shares in the authorized insurance entity or its parent, or that enable the acquirer (even if holding less than 10%) to exercise significant influence over the management of the authorized insurance entity or its parent, or (ii) acquires or holds 10% or more of the voting rights in the authorized insurance entity or its parent, will become a "controller" of the insurance entity and will be required to obtain consent for the acquisition. In the U.K. and other EU member states, it is necessary to obtain either consent before becoming a controller or to have provided certain relevant information to the insurance regulatory authorities and have received no objection within a 60 working-day period.

One of the difficulties for prospective private equity investors is to ascertain whether their proposed investment will trigger "control" issues and require approval. Given that "significant influence" can exist irrespective of the size of shareholding and the fact that "associates" of potential controllers (whether persons or corporations) are combined (as are persons acting in concert) with the potential controller in determining whether control exists, this is not always an easy test to answer.

Private equity investors should also note that the control test does not arise only at the time of the initial investment but will continue throughout the investment and may also be applicable on exit. Most EU jurisdictions have specified levels of "control" whereby any change in shareholding (or shareholding arrangements pursuant to a shareholders' agreement) that go through bands of 10%, 20%, 30% or 50% or more (whether increasing a shareholding or decreasing a shareholding) will require a notification and/or consent to be obtained.

One improvement in the EU "control" regime arising from the Acquisitions Directive is the establishment of a common set of criteria by which would-be "controllers" are to be considered, thus (at least in theory) removing any discrepancies in treatment by national regulatory bodies and creating a standardized approach to controller applications throughout the EU. The specified criteria against which prospective "controllers" are to be considered are:

- The reputation of the potential acquirer of control.
- The reputation and experience of any person who will direct the business of the target company as a result of the proposed acquisition of control.
- Whether the target company will be able to comply on an ongoing basis with prudential requirements under the relevant EU directives.
- Whether there are reasonable grounds to suspect that in connection with the proposed acquisition of control any money-laundering or terrorist financing is being committed or that the proposed acquisition could increase the risk of this occurring.

These are the only criteria to be applied (so individual member states may not apply any additional ones).

Prospective private equity investors in listed companies that are, or are the parent of, authorized insurers within the EU should bear in mind that (as a result of the EU Transparency Directive) EU jurisdictions are now requiring public notification to be given regarding the acquisition or disposal of shares within specified percentage thresholds (these being, in the case of the acquisition or disposal of shares in a U.K.-listed company, 3% and every whole percentage figure above 3%).

In addition to insurance regulatory consents, prospective private equity investors in transactions involving insurers in the EU will also need to be mindful of EU competition laws. In addition, each EU member state will have its own national competition laws applicable to mergers.

While a private equity investor should, in principle, be less concerned with competition issues than a strategic buyer or investor, a private equity investor that has made numerous investments in the EU insurance sector would have to consider the competition issues prior to investment, especially since competition authorities may view specific classes of insurance business as separate markets in their own right when determining whether an applicable concentration of interests or merger is taking place.

7. IMPLICATIONS OF REGULATORY DEVELOPMENTS: THE DODD-FRANK ACT

The enactment of the Dodd-Frank Act has of course had enormous significance for all participants in the U.S. financial services industry, even though much of the ultimate impact of the new law on most participants in the market will not come into sharp focus until the rule-making process under the Dodd-Frank Act has been completed. The Dodd-Frank Act has affected insurers in a number of ways, and is likely to have a significant impact on the relatively limited number of insurers who may potentially be subject to regulation as systemically important financial institutions, and insurers who own banks or savings and loan associations, which will be subject to new and enhanced regulatory requirements applicable to bank and thrift holding companies.

However, for the vast majority of insurers, the enactment of the law itself, even absent the completion of implementing regulations, may actually have assuaged concerns of investors in the insurance and insurance services industries about the federal regulatory environment and other uncertainties that would apply to the industry in the wake of the Great Recession, at least for the intermediate term. Among these uncertainties has been the extent to which the financial crisis would lead to substantial federal regulation of the insurance industry. The Dodd-Frank Act does create a Federal Insurance Office ("FIO") with the power to require insurers, under certain circumstances, to produce data or information, but the FIO does not have any supervisory authority

over insurance companies.[7] While the Dodd-Frank Act did not create an optional or mandatory federal charter for insurers, the FIO was tasked with conducting a study on how to modernize and improve the system of insurance regulation in the U.S. This study, which was supposed to be completed by January 21, 2012 and must examine an optional federal charter (at least for certain insurers), has not been published as of this writing.

Insurers may be affected by the Dodd-Frank Act in a number of areas in their operations. For example, potential changes to the standard of care applicable to broker-dealers could affect the way in which variable annuities and variable life products (which are subject to registration under the Securities Act of 1933) are marketed and sold. While insurance products are expected to be excluded from new regulation applicable to swaps, certain insurers may be affected in their use of derivatives in investment and hedging transactions. Unless an exemption applies, such activities may be subjected to mandatory margin, clearing and reporting requirements once rules are finalized. An insurer may become a "major swap participant" or major security-based swap participant," which would subject such insurer to registration requirements and other proposed regulations.

The Dodd-Frank Act also provides for the harmonization of reinsurance credit rules applicable to U.S. ceding insurers and the regulation of excess and surplus lines reinsurers (in each case removing

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[7] Note that the director of the FIO will serve as a non-voting member in the new Financial Stability Oversight Council established by the Dodd-Frank Act to identify systemic risk and systemically important financial companies. The FIO will also play a role in any recommendation to designate an insurer or insurer affiliate as a systemically important non-bank financial company subject to regulation by the Federal Reserve Board and in the determination to subject an insurer or insurance holding company to the new regime for orderly liquidation of financial companies whose failure would pose systemic risk to the financial stability of the U.S. The FIO will also have a role in negotiating international agreements that could preempt state insurance laws and regulations.

the burden of inconsistent state regulation), a development that should simplify, not complicate, the operations of most insurers. Insurers are also generally exempted from the new consumer financial protection regulations embodied in the Dodd-Frank Act. In addition, the purchase, sale, acquisition or disposition of securities or other instruments by a regulated insurance company for the general account of the company or by an affiliate of such regulated insurance company solely for the general account of the insurance company or "on behalf of customers" in a separate account is, subject to certain requirements and exceptions, exempted from the proposed Volcker Rule's restrictions on such activities by FDIC-insured depository institutions and their affiliates.[8]

As a consequence, while it is expected that regulatory changes under the Dodd-Frank Act may ultimately create new business and regulatory costs and burdens for insurers, it does not appear to fundamentally alter, at least in the intermediate term, the state-based regulatory regime that has historically governed the core insurance operations of U.S. insurers.

8. PRIVATE EQUITY FIRMS AS BUYERS AND SELLERS: PURCHASE AGREEMENT ISSUES

a. Buy Side Issues

Because of their desire for predictable cash flows to service debt, financial buyers may be particularly sensitive to protecting against liabilities that are not reflected on a target insurer's balance sheet.

For instance, a financial sponsor buyer may seek to negotiate for strong representations as to the adequacy or sufficiency of insurance reserves and the collectability of reinsurance recoverables. However, some

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8 Regulators are still in the process of finalizing the Volcker Rule.

sellers of insurance companies resist any such representations or warranties or related indemnities (except for a conventional GAAP or STAT representation), thereby insulating sellers from most post-closing risk associated with any aspect of such assets and liabilities as of the closing. Ultimately, however, this is a risk allocation issue, the outcome of which will likely affect the pricing of the transaction.

As a result of regulatory investigations focusing on practices in the insurance industry such as contingent commissions and finite reinsurance, some insurers had to restate their financial results and balance sheets and take other actions that changed projected income streams and cash flows. Because of the sensitivity of financial buyers to such instability in financial prospects, deals entered into in the aftermath of such investigations involving private equity investors have featured greater protections by way of representations and warranties and indemnification packages regarding these matters, as protection with regard to, for example, sales practice claims. While protections regarding such matters have become more prevalent in recent years, even in deals involving strategic purchasers, the difficulties in assessing the regulatory risk associated with any particular insurance company acquisition inevitably leads to contentious negotiations over the allocation of risk with respect to a potential regulatory investigation of the target. This negotiation is further complicated by the fact that the damages resulting from such an investigation may consist more of lost profits, damaged reputations and other consequential damages than the more conventional out-of-pocket damages covered by many indemnities.

b. Sell Side Issues and Exit Strategies

Depending on market factors and the characteristics of a particular insurance investment, buyout sponsors typically exit their investments through either an initial public offering or a private sale of their interest to a third party. A registration rights agreement negotiated at the time of the initial investment will typically give the buyout firm control over

the timing of, and the participants in, a public offering in which it will sell its shares. In a private sale to a third party, a buyout firm will resist providing post-closing indemnification since sale proceeds are typically distributed immediately to limited partner investors in the fund, under some circumstances without possibility of a claw-back. In some circumstances, however, private equity sellers agree to escrow a limited portion of the sale proceeds for a limited period of time (often one year) to provide an exclusive source of indemnification payments to a third-party buyer.

c. Financial Assistance

In the U.K. and certain other European jurisdictions one significant issue on both the buy side and on the sell side is national law prohibiting companies from the giving of unlawful "financial assistance." These laws are significant because failure to comply with them may render the company involved, *and its officers*, liable to fines (and potential imprisonment), may render the transaction void and unenforceable, and may impose personal liabilities on the company directors involved for breach of fiduciary duty.

Prior to October 1, 2008, when the U.K. regime on financial assistance was liberalized, the prohibition on the giving of financial assistance could have a material impact on a private equity investment. Unless one of the applicable statutory exceptions applied, or the "whitewash" procedure could be followed so as to permit the giving of the assistance to be rendered lawful by (among other things) the company's shareholders approving the transaction, the following types of transaction could constitute unlawful financial assistance and therefore be illegal:

- Target paying the due diligence costs of private equity investors.
- Target paying the legal costs of private equity investors in negotiating and documenting the transaction.

- Target entering into loan arrangements with private equity investors (even after the investment has happened).
- Target granting security over its business or assets in favor of private equity investors or lenders to private equity investors.
- Target paying legal costs of private equity investors on their "exit."
- Target surrendering available tax losses up to private equity investors or parent company.
- Target allowing private equity investors to invest on deferred terms.
- Target giving representations and warranties or indemnities to private equity investors as part of the purchase agreement for investment in target's shares.

Fortunately for those involved in private equity investments, the U.K. prohibition on the giving of financial assistance was removed in the case of private companies by the Companies Act 2006, the relevant provisions of which came into effect on October 1, 2008 (see Section 3.a(4) of Chapter Two). For public companies whose shares are being or have been acquired (or for any of that company's subsidiaries), it will continue to be unlawful to give financial assistance for the purpose of that acquisition unless certain limited exceptions apply. The prohibition is extended to cover any financial assistance given to reduce or discharge any liability incurred by the company or any third party for the purpose of the acquisition (including the types of financial assistance referred to above). One route around the continuing prohibition on the giving of financial assistance by public companies (assuming there is no need to retain public company status, for example, due to any ongoing stock exchange listing) will be to re-register the public company as a private company before the financial assistance is given and then take advantage of the ability of private companies to give financial assistance. Given that one of the key types of financial assistance that buyers often wish to

secure is payment of their costs on inward investment, this is a potentially valuable relaxation for sellers.

9. CONCLUSION

While investing in insurance and insurance services companies creates some unique challenges for private equity firms, it also affords important opportunities, especially given the enduring nature of the insurance business, its inevitable growth over time, its relatively stable cash flows and a cyclical nature which often parallels the 5-7 year investment horizon of a typical private equity investment. These opportunities, together with the historic activities of private equity sponsors in the insurance sector, suggest to us that private equity investments in the insurance industry will continue amid the current conditions and the associated regulatory developments and ultimately adapt to, and profit from, the evolving realities of the insurance industry.

CHAPTER FOUR — INSURANCE REGULATORY APPROVAL REQUIREMENTS FOR A STOCK PURCHASE DEAL

STEVEN OSTNER, NICHOLAS F. POTTER, JEREMY HILL AND JOHN DEMBECK[1]

1. ACQUISITION OF CONTROL

The acquisition of stock in an insurer or its holding company always has the potential to trigger a requirement to obtain prior regulatory approval. The expression "acquiring control" in this context can be slightly misleading, as the acquisition of even a relatively small proportion of issued stock may be classed as "control" for regulatory purposes.

The threshold at which regulators will need to be consulted is commonly set, in the U.S. and across Europe, at 10% of stock or of voting rights and will therefore always be crossed where an acquiror who currently holds none of the Target's stock proposes to acquire it in its entirety. It is worth noting, however, that a degree of control requiring regulatory approval may also be acquired in other ways, such as through the ability to exercise significant influence over the management of an insurer or any of its holding companies. It is also important to bear in mind that, in some circumstances, stock or voting rights held by apparently unconnected entities may be viewed in concert for the purposes of determining whether and, if so, what control thresholds have been reached.

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[1] Steven Ostner, Nicholas F. Potter and Jeremy Hill are partners in, and John Dembeck is counsel with, Debevoise & Plimpton LLP. © 2012 Debevoise & Plimpton LLP. All rights reserved. Portions of this Chapter may appear in other materials published by the authors or their colleagues.

a. Analysis of Operations

In Chapter Two, we noted the importance of conducting a thorough analysis of the geographic scope of the Target's operations from a due diligence perspective. Such an analysis is also important in determining which regulatory authorities may need to be approached for the filings and approvals required to complete the transaction and an acquiror will therefore wish to conduct this exercise at an early stage in the transaction.

It will generally be important to distinguish between the territories in which the Target and/or its subsidiaries are incorporated or otherwise established, on the one hand, and territories in which they have merely offered their policies or in which their policyholders are resident, on the other: different regulatory requirements may apply to each of these situations.

b. Regulatory Framework for U.S. Insurers

Insurance business in the U.S. has been regulated primarily by individual states since the 1800s. Promptly after a U.S. Supreme Court decision in 1944, which held that insurance transactions that stretched across state lines constituted interstate commerce subject to regulation by the U.S. Congress under the Commerce Clause of the U.S. Constitution and thus subject to federal antitrust laws,[2] Congress passed the McCarran-Ferguson Insurance Regulation Act in 1945 which (i) declares that the business of insurance is to be regulated by the states, and (ii) exempts the business of insurance from the federal antitrust laws to such extent that such insurance business is regulated by the states, except as to agreements to boycott, coerce or intimidate.[3]

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[2] *See* United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533, 64 S. Ct. 1162, 8 L. Ed. 1440 (1944).

[3] 15 U.S.C. §§ 1011-1015.

Each state has its own insurance laws and regulations and each state has its own chief insurance regulator, usually called a Commissioner but sometimes referred to as a Director or Superintendent. These laws and regulations apply to insurers that are incorporated (and thus "domiciled") in the state but may also apply to insurers domiciled elsewhere, that have nevertheless transacted a certain level of business within that state. The effect of this is that more than one state may have an interest in reviewing and approving the proposed acquisition of control of a U.S. insurer.

c. Regulatory Framework for European Insurers

All EU jurisdictions are subject to a number of EU directives designed to achieve harmonization of prudential requirements for insurers, including the approval of new controllers, across the EU. Although these directives are themselves binding on each Member State, the manner in which each state implements a directive inevitably differs slightly from state to state. However, key regulatory principles, such as the basic threshold for acquiring "control" and the period allowed for approval of new controllers, are common across EU jurisdictions.

The position in the EU is slightly different from that which prevails in the U.S.: the only regulator whose approval of a controller should be required for the purposes of the proposed acquisition of an EU insurer is the regulator in the EU Member State in which that insurer is incorporated (the so-called "home state" regulator). Thus, if the Target has merely provided insurance, either through a branch or on a direct basis, in another EU member state without establishing a separate corporate entity there, the regulator within that state (the "host state") will not need to be approached for approval of the acquisition.

The directives did not apply these helpful "passport" procedures to pure reinsurers and, historically, all EU Member States had been free to regulate reinsurance or not, as they saw fit. However, on October 17, 2005, the Council of the European Union adopted a new Reinsurance Directive designed to provide for the first time a system of common

regulation of reinsurers throughout the EU. The Reinsurance Directive embodies the key principle of mutual recognition, so that, once authorized in any member state, a reinsurer will not have to obtain authorization to conduct its business in any other. The Reinsurance Directive therefore applies to EU reinsurers the same "home state regulates" principle as applies to EU insurers.

2. INSURANCE REGULATORY APPROVAL OF ACQUISITION OF CONTROL OF A U.S. INSURER

a. Holding Company Regulation in State of Domicile

Every state has either an insurance holding company act or some other very similar statute. Most of these statutes are based upon the National Association of Insurance Commissioners ("NAIC") Insurance Holding Company System Regulatory Act (the "NAIC Model Act") although there are some variations from jurisdiction to jurisdiction. With the advent of NAIC accreditation of states in the early 1990s, which requires that a state enact a insurance holding company act substantially similar to the NAIC Model Act in order for a state to become and remain accredited by the NAIC, many states conformed their insurance holding company acts to the NAIC Model Act in the early to mid-1990s. Any reference to the NAIC Model Act in this Chapter will refer to the NAIC Model Act as adopted by the NAIC with amendments through 2001. Significant additional amendments to the NAIC Model Act were adopted by the NAIC in 2010. As states began in 2012 to enact changes to their insurance holding company acts to incorporate changes made to the NAIC Model Act in 2010, important changes based on the NAIC Model Act 2010 changes are identified throughout this Chapter.

In any insurance M&A transaction involving a U.S. insurer, the state of domicile of the Target insurer (the jurisdiction in which it is incorporated) is critical because it determines the applicable state regulatory regime and which state insurance regulator(s) will review the

application for approval of acquisition of control. Prior approval of the acquisition of control of a U.S. insurer or an entity that itself controls a U.S. insurer is virtually always required from the domestic state insurance regulator of the U.S. insurer. Where an insurance holding company system is to be acquired, prior approval of the acquisition must be obtained from the state insurance regulator of each state where each U.S. insurer within the system is domiciled. Approval is required whether acquisition of control is sought by means of a tender offer, open market purchases, holding proxies or in any other manner, including the purchase of either direct or indirect control.

Failure to obtain the required approval of the acquisition will generally result in (i) the securities being made ineligible to vote at a shareholders' meeting, and (ii) a shareholder vote being taken as though the securities were not issued or outstanding. In addition, the Target insurer (usually in a hostile takeover) or the state insurance regulator may apply to a court in the Target insurer's domestic state to (i) enjoin the voting of any security acquired in violation of law, and (ii) seize or sequester the securities. Lastly, monetary penalties can generally be imposed by the state insurance regulator for the violation of law.

(1) What Is "Control"?

"Control" is a key word in state insurance holding company acts. Control arises if the acquiror is seeking to acquire control of (i) a person that controls a domestic insurer, or (ii) the domestic insurer itself. Therefore, one of the first questions that must be asked under any state insurance holding company act is: what is "control"?

The definition of "control" in the NAIC Model Act is "the possessing of direct or indirect power to direct the management and policies of a person, through ownership of voting securities by contract or otherwise." It is a very general definition. However, most of the statutes set forth a rebuttable presumption regarding when the acquiror has acquired control. In the NAIC Model Act, the presumption applies if the acquiror holds proxies or controls 10% or more of the voting

securities of any person. "Voting securities" is defined in the NAIC Model Act to include any security convertible into or evidencing a right to acquire a voting security. Thus, bonds convertible to voting stock or warrants that can be exercised to acquire voting stock will, in most states, constitute voting securities. There are some variations from state to state. For example, for Alabama and Florida, the presumption of control arises at 5%. If the acquiror acquires direct or indirect control over the voting securities of a domestic insurer, or would acquire control if the transaction went forward, there is a presumption that the acquiror has acquired control. The presumption can be rebutted; however, in most instances this must be done by making a formal request for approval of the Target insurer's domestic state insurance regulator that the proposed transaction is exempt from the acquisition of control approval requirement.[4] An acquiror knows that, once the threshold percentage level is acquired, it is within the mechanics of the Target insurer's state insurance holding company act and the regulatory process has started and some kind of action by the acquiror is required.

The issue of control may arise in an unexpected way where two non-U.S. companies have a cross-ownership relationship in excess of 10%. For example, where Company A owns 15% of the voting stock of Company B, and Company B owns a U.S. insurer, an acquisition of control of Company A would require U.S insurance regulatory approval in the U.S. insurer's state of domicile even though Company A has no U.S. operations at all. In a contested acquisition, this may involve the buyer of Company A in a drawn-out U.S. insurance regulatory process. In a friendly acquisition, it may often prove to be the case that Companies A and B have previously obtained an exemption fro the acquisition of control approval requirement which may provide grounds for seeking a similar approval for an exemption.

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[4] For further discussion of exemptions, see Section 2.a.3 of this Chapter Four.

The provisions of the NAIC Model Act do not require a person who has previously obtained approval to acquire control of a U.S. insurer to make a further application and obtain approval to increase its shareholding in the same insurer. Thus, if a person has already been approved to acquire 25% of the voting securities of an insurer, that person need not make an application and obtain an approval to acquire an additional 25%, 50% or 75% of the voting securities of the same insurer. However, a state insurance regulator could, as a condition of issuing the original approval to acquire 25% of the voting securities of an insurer, require that the controlling person obtain an additional approval to increase its shareholding at a later date. Thus, it is important to review all conditions attached to the original approval of an acquisition of control of an insurer. Even if regulatory approval is not required to increase a shareholding, it is nevertheless good regulatory practice to give notice to the applicable domestic state insurance regulator.

(2) When Must the Application Be Filed?

Although most state insurance holding company acts require the prior approval of the state insurance regulator before the acquiror seeks or enters into an agreement to acquire control of the domestic Target insurer, it is generally thought that an offer to acquire control, or entry into a purchase agreement, does not violate the statutes if it is expressly made subject to obtaining approval of the Target insurer's domestic state insurance regulator. An important strategic consideration will be deciding when to approach the Target insurer's domestic state insurance regulator, at least informally, to begin making the case for approving the acquisition of control.

(3) Exemption from Prior Approval Requirement

Most state insurance holding company acts follow the NAIC Model Act which allows an acquiror to seek an order from the Target insurer's

domestic state insurance regulator that a transaction should be exempt from the acquisition of control prior approval requirements. Exemptions are typically available if the acquisition (i) is not entered into for the purpose and does not have the effect of changing or influencing the control of the domestic insurer, or (ii) is otherwise not comprehended within the purposes of the statute.

(4) Form and Content of the Application for Insurance Regulatory Approval

If an acquiror seeks to acquire control of an insurer, it must file a "Form A" application for approval of the acquisition of control with the Target insurer's domestic state insurance regulator. The form is named "Form A" in the NAIC Insurance Holding Company System Model Regulation (the "NAIC Model Regulation") promulgated in some form by most states. Any reference to the NAIC Model Regulation (and its Forms A-F) in this Chapter will refer to the NAIC Model Regulation as adopted by the NAIC with amendments through 1993. Significant additional amendments to the NAIC Model Regulation were adopted by the NAIC in 2010. As states began in 2012 to promulgate changes to their insurance holding company regulations to incorporate changes made to the NAIC Model Regulation in 2010, important changes based on the NAIC Model Regulation 2010 changes are identified throughout this Chapter.

The state insurance holding company acts generally authorize the state insurance regulator to promulgate a regulation setting forth the information to be submitted in an application for approval of the acquisition of control of a domestic insurer. The usual application form requires the following kinds of information: (i) identification of the insurer to be acquired and the method of acquisition, (ii) identification of the acquiror and background information on the acquiror including a detailed organization chart, (iii) background information regarding directors and executive officers of the acquiror and regarding individuals who own 10% or more of the acquiror (including completion of

biographical affidavits), (iv) a description of the nature, source and amount of consideration including disclosure of any borrowing to fund the purchase, (v) a discussion of future plans of the Target insurer, and (vi) financial statements of the acquiror. For states that have amended their insurance holding company acts to follow the 2010 changes to the Model Act and their Form A to follow the 2010 changes to the Model Regulation, the applicant must also (i) file a "Form E" – Pre-Acquisition Notification – setting out market share data relating to the competitive impact of the Target insurer's domestic state, and (ii) commit to make an annual "enterprise risk" report which must identify the material risks within the holding company system that could pose enterprise risk to the Target insurer.

Some states (*e.g.*, Arizona, California, New York and Texas) require that directors and officers of the acquiror submit fingerprints as part of the regulatory review of the trustworthiness of these individuals. Some states require an exhaustive discussion of future plans for the Target insurer (dividends, liquidation, sale of assets, mergers, changes to business operations, corporate structure and management and material agreements or transactions of any kind). Still other states will require statutory financial projections for the Target insurer. The administrative practice of the New York Department of Financial Services, for example, is to require submission of a plan of operation — in essence, a business plan for the Target insurer — and (for the acquisition of life insurers) actuarial projections of the financial results of the plan of operations projected over a period of three years for seasoned insurers or five years for new insurers. For states that have amended their insurance holding company regulations and their Form A to follow the 2010 changes to the Model Regulation, three-year financial projections of the Target insurer are required to be included in the Form A.

Where an acquiror is a private equity fund or other investment vehicle that has an individual or group of individuals as its ultimate control person(s), a key concern is whether or not the individuals will have to submit personal audited financial statements as part of the Form A. The Form A instructions generally require audited financial statements be

submitted by the applicant and each affiliate of the applicant (persons under common control using the 10% presumed control threshold). In the case of an individual applicant, some states may waive the requirement, some may allow the submission of substitute documentation (recent tax return or net worth affidavit) and some may require actual compliance with the personal audited financial statement requirement. To the extent that any personal financial information is required to be submitted as part of the Form A, efforts need to be made to seek the maximum protection from public disclosure for the information submitted. A private equity fund may also have concerns about the extent to which a Form A and its exhibits will be made available to the public on request, especially since a Form A typically requires the inclusion of an organization chart for the acquiring group together with audited financial statements of the funds making the acquisition and even their controlling persons. In this case, it may be prudent to determine whether any part of a Form A can be protected from public disclosure, under state public disclosure laws, prior to making the filing in any state.

(5) Standard of Review and Hearing

Generally, a domestic state insurance regulator may disapprove an acquisition of a domestic insurer only if he or she finds, after a hearing, that: (i) after the acquisition of control, the domestic insurer would not be able to satisfy the requirements for the issuance of a license to write the line or lines of insurance for which it is presently licensed; (ii) the effect of the acquisition of control would be substantially to lessen competition in insurance in the state or tend to create a monopoly therein; (iii) the financial condition of any acquiror is such as might jeopardize the financial stability of the insurer, or prejudice the interests of its policyholders; (iv) the plans or proposals which the acquiror has to liquidate the insurer, sell its assets or consolidate or merge it with any person, or to make any other material change in its business or corporate structure or management, are unfair and unreasonable to policyholders of the insurer and not in the public interest; (v) the

competence, experience and integrity of those persons who would control the operation of the insurer are such that it would not be in the interest of policyholders of the insurer and of the public to permit the merger or other acquisition of control; or (vi) the acquisition is likely to be hazardous or prejudicial to the insurance buying public.

In some states (*e.g.*, Connecticut, Missouri and Washington), insurance laws require a public hearing for all Form A applications. In most states, the applicant is generally entitled to a hearing before the regulator may deny the application. In states where a hearing is discretionary, a state insurance regulator may desire a hearing if the transaction submitted for approval draws an unusual degree of interest from policyholders, the insurance industry or the public.

b. Possible Prior Notice or Approval in States Other Than the State of Domicile

In addition to obtaining approval for the acquisition of control in the Target insurer's domestic state, it may also be necessary for the acquiror to give notice to or obtain approval of insurance regulators in other states where the Target insurer is licensed to transact an insurance business.

(1) In Which States Is the Target Commercially Domiciled?

There are six states that require approval of acquisitions of control of insurers "commercially domiciled" in their state. In order to be deemed to be "commercially domiciled" in most of the six states, an insurer, in the last three fiscal years taken together, must have written (i) an amount of gross premiums written (direct premiums in California) in that particular state which is greater than that written in its state of domicile, and (ii) at least a specified percentage in that state as compared to what was written in all U.S. jurisdictions in the aggregate. For example, if an insurer is domiciled in Kansas, but wrote, in the last three fiscal years

taken together, at least 33% or more of its direct premiums in California and wrote more direct premiums in California than it wrote in Kansas, it would be deemed to be commercially domiciled in California and be subject to the insurance holding company act provisions of California (in addition to those of Kansas). The percentages are different in each of the commercial domicile states. If an insurer is commercially domiciled in a state, then that state's insurance holding company act applies to the insurer as if it were a domestic insurer. This means that the acquiror will have to submit a "Form A" acquisition of control application with the commercial domicile state insurance regulator as well as the insurer's domestic state insurance regulator.

(2) Pre-Acquisition Notification Based on "Market Share"

The laws of a state, other than the state of domicile of the Target insurer, may be relevant to an acquisition of control of a Target insurer licensed in one or more "market share" states. There are 25 states (and the District of Columbia) that have enacted an NAIC Model Act "market share" provision. This provision requires that an acquiror that seeks to acquire control of a foreign licensed insurer in the state give 30 days' notice (60 days in the State of Washington) to the state insurance regulator to allow the regulator to evaluate the effect of the acquisition on competition in the state. Whether notice is required depends on the market share of the acquiror and the Target in individual lines of business, based on premiums written in the state. Premium information by line of business can be found in insurance industry databases, which should be reviewed early in the due diligence process. If the two (or more) combined insurers (the acquiror and the Target) have a minimal market presence, no impact on the market is deemed to have occurred that the regulator will have to evaluate. If (i) the combined company has less than 5% of the total market, (ii) there would be no increase in market share as a result of the acquisition of the Target (*e.g.*, for a given line of business in a state, only one of the acquirer or the Target writes the line), or (iii) the combined company has less than 12% of the total market and, as a result of the acquisition of the Target, there is no

increase in the market share of more than 2%, no "market share" filing need be made. Where a "market share" filing is required, the notice is usually submitted on "Form E" — Pre-Acquisition Notification.

(3) Relicensing and Other Notification Requirements

Certain states (including Michigan and New Hampshire) have statutes requiring re-licensing of an insurer upon an acquisition of control of a licensed insurer, and still other states (Colorado and Florida) have statutes requiring some kind of post-closing filing following an acquisition of control of a licensed insurer. One state (California) requires a special post-closing filing by the insurer in the event that the Target insurer is a corporate shell or when the sale will result in a significant change in the Target insurer's operations. In addition, some states (Minnesota and North Carolina) require post-closing written notice of changes in the controlling stock of foreign licensed insurers. It is good practice to give post-closing written notice to all states in which the Target insurer is licensed to transact an insurance business.

3. OTHER INSURANCE REGULATORY ISSUES WHICH MAY ARISE ON A STOCK PURCHASE OF A U.S. INSURER

a. Government Ownership Statutes

The insurance laws of some 29 states restrict or prohibit the licensing of insurers which are owned or controlled by government entities. These laws are often vague and are sometimes ignored by state insurance regulators in granting licenses. In the mid-1990s, these laws were relaxed in several states by amendments that changed the old, absolute prohibition into a prohibition that applies only if the acquiror is both state-owned and benefits from a subsidy. However, in a private acquisition or a friendly acquisition of a publicly traded corporation where the acquiror has government ownership, these statutes must be

analyzed to ensure that licensure issues do not arise after the closing. In a contested situation, these statutes may form part of a defensive strategy against a government-controlled acquiror.[5]

b. Broker-Controlled Insurer Business Laws

In 1989, following regulatory concerns arising out of the failure of the Union Indemnity subsidiary of Frank B. Hall & Co., Inc., the NAIC adopted two model laws to control relationships between producers (brokers) and insurers: the Business Transacted with Producer Controlled Property/Casualty Insurer Act (the "Producer-Controlled Insurer Act") and the Disclosure Requirement for Business Transacted with a Property/Casualty Insurer Act (this model law was archived in 2003). The Producer-Controlled Insurer Act has been widely enacted into law, because its enactment is a condition to NAIC accreditation of a state. The Act applies only to relationships between producers and property/casualty insurers — *i.e.*, not to relationships with life insurers.

While the Producer-Controlled Insurer Act (as amended in 1991) does not bar a producer from owning an insurer or an insurer from owning a producer, it does require (i) that the relationship between a producer and an insurer which it controls be disclosed to prospective insureds, (ii) annual actuarial reports on controlled business (business placed by the producer with its controlled insurer) be filed, and (iii) commissions paid on controlled and uncontrolled business be reported. In the event that a licensed insurer controlled by a producer becomes insolvent and the receiver believes that the controlling producer has not materially complied with the law, and the insurer suffered any loss or damage because of such noncompliance, the Act authorizes the receiver to "maintain a civil action for recovery of damages or other appropriate sanctions for the benefit of the insurer." To the extent that a

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5 For further discussion of government ownership issues, see Section 3.b of Chapter One.

property/casualty insurer's stock is being acquired directly or indirectly by a producer, the acquiror will need to comply with the disclosure requirements of the Act with effect from closing forward.

The Producer-Controlled Insurer Act incorporates by reference the definition of "control" from the state's insurance holding company act., so the presumed control threshold is generally ownership or control of 10% or more of a person's voting securities. One state, Alabama, uses a 5% presumption of control threshold but the version of the Act enacted in Alabama applies only to a domestic insurer or an insurer domiciled in a state that is not NAIC-accredited. Therefore, a 5% presumed control threshold will apply if the insurer that is controlled by the producer is an Alabama domestic property/casualty insurer.

c. Regulation of Shareholder Dividends

Most insurance holding company acts contain a provision that imposes restrictions on the payment of both ordinary dividends and "extraordinary dividends" by a domestic insurer. First, dividends, whether ordinary or extraordinary, may usually be paid only out of earned surplus (accumulated earnings and not surplus that was paid-in from the sale of stock). "Earned surplus" is often defined or interpreted to mean "Unassigned funds (surplus)" as reported on an insurer's statutory financial statement filed with state insurance regulators. Second, "extraordinary dividends" may not be paid until: (i) 30 days after the insurer's domestic state insurance regulator has received notice of the declaration thereof and has not, within the 30-day period, disapproved the payment, or (ii) the insurer's domestic state insurance regulator approves the payment within the 30-day period. An "extraordinary dividend" is usually defined to mean a dividend or distribution of cash or other property whose fair market value, together with other dividends and distributions made within the last 12 months, exceeds the greater of: (i) 10% of the insurer's policyholders' surplus as of the preceding December 31, or (ii) the net income of the insurer for the 12-month period ending the preceding December 31.

These provisions are relevant if the acquisition contemplates a pre-closing shareholder dividend by the Target insurer to its parent or if the acquiror has plans for future shareholder dividends paid by the Target insurer.

d. Regulation of Affiliate Transactions

Under state insurance holding company acts, all transactions between a controlled insurer and any member of its holding company system (affiliate transactions) will be subject to the following standards whether or not they are subject to regulatory review: (i) the terms must be fair and reasonable; (ii) the charges and fees for services performed must be reasonable; (iii) expenses incurred and payment received must be allocated to the insurer in conformity with customary insurance accounting practices consistently applied; and (iv) the records of each party to such transactions must be clearly maintained, and must support the reasonableness of the charges and fees.

Furthermore, certain transactions, like entering into a servicing agreement, a material purchase or sale of assets between a domestic controlled insurer and any member of its holding company system or entering into a material reinsurance agreement between a domestic controlled insurer and any member of its holding company system, must be submitted to the insurer's domestic state insurance regulator for prior review on "Form D" – Prior Notice of a Transaction. For states that have amended their insurance holding company acts to follow the 2010 changes to the Model Act, transactions subject to prior review on "Form D" include a reinsurance pooling agreement (without regard to any materiality threshold), a tax allocation agreement and any amendment or modification to a previously filed transaction.

Among the kinds of affiliate transactions that may be contemplated in connection with an acquisition of control of a Target Insurer that may be subject to a "Form D" filing and prior regulatory review are (i) a pre-closing reinsurance agreement entered into between the Target insurer and an affiliate, (ii) the Target insurer becoming a party to the acquiror's

existing reinsurance pooling agreement on the closing date, and (iii) the acquiror or its affiliate agreeing to provide administrative services to the Target insurer on and after the closing date.

e. Specialty Insurers

There are other kinds of U.S. insurance or risk-assuming entities, other than stock insurers, for which an acquisition will also require a prior state insurance regulatory approval.

The state insurance holding company acts often define an "insurer" whose acquisition requires prior approval in different ways. California, for example, defines an insurer for purposes of its insurance holding company act as "every organization organized for purposes of assuming the risk of loss under contracts of insurance or reinsurance." This is a very broad definition that may sweep up all kinds of risk-assuming entities other than stock insurers. Similarly, Texas defines an "insurer" subject to its insurance holding company act to include various mutual companies, a fraternal benefit society, a Lloyd's plan, a reciprocal insurer and a group hospital service corporation. It is important in any acquisition of U.S. risk-assuming entities to determine whether the entity's domestic state insurance holding company act includes the entity as an "insurer" and thus will require a prior approval for its acquisition.

The Florida insurance law has a special acquisition of control law applicable to "specialty insurers." "Specialty insurers" are defined to mean any one of 11 risk-assuming entities that are licensed to do business in Florida. These include a motor vehicle service agreement company, a home warranty association, a service warranty association, certain health maintenance organizations and a premium finance company. Significantly, this acquisition of control law applies to any specialty insurer that is licensed to do business in the state, not just those domiciled (organized) in the state.

Unlike state insurance holding company acts, the Florida specialty insurer acquisition of control law requires that the person seeking to

acquire 10% or more of the outstanding voting securities of a specialty insurer file a letter of notification regarding the transaction or proposed transaction no later than 5 days after the acquisition of the securities or ownership interest. An application to acquire control of a specialty insurer must be filed within 30 days after the acquisition of the securities or ownership interest. In the case of an acquisition to be made pursuant to a stock purchase agreement that contemplates a subsequent acquisition closing, the Florida Office of Insurance Regulation has indicated that each of these time periods commence with the signing of the purchase agreement. Late filings are subject to monetary penalties so it will be important to identify any Florida specialty insurer to be acquired early on in the due diligence process to be sure that the acquiring person has the required Florida filing ready for timely submission.

Also, unlike state insurance holding company acts, the Florida approval of an acquisition of control of a specialty insurer need not be obtained before the acquisition closing date. However, if the approval is to be obtained after the acquisition closing date, then any material change to the operation of the specialty insurer after closing will require prior Florida regulatory approval and any material change in the management of the specialty insurer will require notice and is subject to disapproval by the Florida regulator.

f. Health Maintenance Organizations

An acquired insurance group may include one or more health maintenance organizations ("HMOs") – a type of managed care organization that provides a form of health care coverage in the U.S that is fulfilled through hospitals, doctors, and other providers with which the HMO has a contract. HMOs tend to be incorporated and authorized to do business in a single state, although an HMO may be authorized to do business in states other than its state of domicile. While most states regulate HMOs under the insurance law, other states

regulate HMOs under other state laws such as the state's corporation law or public health law.

Acquisition of control of an HMO may require prior regulatory approval under a state's insurance holding company act. Other states have laws regulating HMOs that subject an acquisition of control of an HMO to portions of the state's insurance holding company act. Still other states have laws that include provisions governing the approval or notice of modifications to the information contained in the applications for a certificate of authority submitted by the HMOs. In general, these laws and regulations set forth the information required to be included in the certificate of authority application, and then provide either that any "material modification" (or, in some states "significant modification" or even "any modification") to that information must be approved in advance by the relevant regulator, or that the regulator must be given notice of any such modification after it has become effective. These laws typically include a 30- or 60-day "deemer" provision, meaning that if the regulator does not object to a proposed modification within the stated time period, the modification will be deemed approved. Each of these kinds of laws must be evaluated in order to determine the regulatory requirements applicable to the acquisition of control of an HMO in a given state.

g. Insurance Agencies

It is not uncommon for a U.S. insurance group to include in their family of companies one or more insurance agencies (intermediaries). State insurance holding company acts apply to insurers and other risk-assuming entities and not to insurance agencies. However, one state, Texas, requires that a person acquiring control of an insurance agency, including a managing general agency, licensed in Texas (whether a resident or non-resident agency) file an application with the Texas Department of Insurance and await an approval (or a deemed approval after 61 days of submission). Therefore, it will be important to identify any Texas licensed insurance agency or managing general agency early

on in the due diligence process to be sure that the acquiring person has the required Texas filing ready for timely submission. At least ten other states require submission of a post-closing notice informing the state insurance regulator of the acquisition of control of a licensed insurance agency. Therefore, it is good practice to give prompt post-closing written notice to all states in which the Target's insurance agencies are licensed.

h. Other Licensed Insurance Entities

States insurance laws also provide for the licensing of other non-risk assuming kinds of insurance entities – insurance brokers, managing general agents, reinsurance intermediaries, surplus lines brokers, third party administrators and adjusters. If the acquired insurance group includes one of these licensees, it is important to know whether a notice of the acquisition of control of the licensee is required under state law. Texas requires a pre-closing notice and approval for an acquisition of control of a third party administrator and public adjuster similar to that required for the acquisition of control of an insurance agency as described in Section 3.g of this Chapter. Some states require submission of a post-closing notice of the acquisition of control of an insurance broker, managing general agent, surplus lines broker and adjuster licensed in their state. More than one-half of the states require submission of a post-closing notice of the acquisition of control of a third party administrator licensed in their state. In any case, it is good practice to give prompt post-closing written notice to all states in which the Target's other insurance entities are licensed.

i. Federal Securities Law Issues Arising from Acquisition of a Life Insurer

If the Target insurer is a life insurer that has separate accounts that underlie variable life insurance policies and variable annuity contracts, an acquisition of control of the insurer may require further approvals.

With certain exceptions, the separate account underlying a variable contract is deemed to be a separate investment company which must, subject to certain exceptions, register under the Investment Company Act of 1940. If the insurer (or its subsidiary) is the advisor to a registered separate account, a "change of control" (as defined in the Investment Company Act) in the advisor will result in the termination of the advisory contract.[6] Approval of the shareholders of the separate account will be needed for a new advisory contact to be entered into between the separate account and the advisor.

4. INSURANCE REGULATORY APPROVAL OF ACQUISITION OF CONTROL OF A U.K. INSURER

a. Financial Services Authority ("FSA")

The FSA is the U.K. regulatory body charged with responsibility, under the Financial Services and Markets Act 2000 ("FSMA"), for approving the controllers of all FSA authorized firms, including insurers. Part XII of FSMA imposes obligations directly on the proposed controller(s) (which includes any person(s) acting in concert with them) to notify the FSA of their intentions in advance. Failure to do so is a criminal offense punishable by fine or imprisonment. The Supervision Manual within the FSA's Handbook of Rules and Guidance (the "Supervision Manual") for authorized firms imposes separate control notification obligations on insurers themselves. Failure by an insurer to comply with the FSA's Handbook is not a criminal offense, though it could lead to disciplinary action by the FSA.

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[6] Investment Company Act of 1940 §§ 15(b)(2) (advisory contract with an investment company must provide for automatic termination in the event of its assignment), 2(a)(4) (assignment includes a transfer of a controlling block of stock). See 15 U.S.C. §§ 80a-15(b)(2) and 80a-2(a)(4).

(1) What Is Control?

Sections 179 through 181 of FSMA define the circumstances in which "acquiring control," "increasing control" and "reducing or ceasing to have control," respectively will occur. The Acquisitions Directive,[7] which came into force on March 21, 2009, introduced a number of changes into FSMA and Chapters 11 and 16 of the Supervision Manual. The key provision for the purposes of a stock acquisition is the holding of 10% or more of the shares (or controlling the exercise of 10% or more of the voting power) in the insurer or a parent undertaking of the insurer. However, other scenarios under the statutory provisions in which "control" may be found to exist include:

- the ability to exercise significant influence over the management of the insurer by virtue of a shareholding or voting power in that insurer (for example, the holding of 5% of the insurer's shares, combined with the right to appoint the majority of the directors of the insurer); or
- the ability to exercise significant influence over the management of a parent undertaking of the insurer by virtue of a shareholding or voting power in the parent undertaking.

Whether the situation is one of acquiring control, reducing control or ceasing to have control, the relevant FSMA provisions apply to (i) the prospective acquiror/controller, (ii) any associates of the prospective acquiror/controller, and (iii) the prospective acquiror/controller and its associates.

Whereas in the U.S., for example, the acquisition by Company A of 12% of the stock of Company B, which itself holds 12% of the stock of a U.S. insurer, would generally create a chain of "control", requiring Company A to obtain prior approval as a controller of the insurer, in the

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[7] 2007/44/EC, implemented into U.K. law by the Financial Services and Markets Act (Controllers) Regulations 2009.

U.K., however, Company B would need to be the "parent undertaking" of the insurer before the acquisition by Company A of 12% of its stock triggered a requirement for Company A to be approved as a controller of the insurer.

The relationship of "parent undertaking" can arise in a number of ways: (i) the parent ("P") holds the majority of voting rights in the insurer; (ii) P is a shareholder in the insurer and has the right to appoint/remove a majority of its directors; (iii) P has the right to exercise a dominant influence over the insurer either through the insurer's constitutional documents or through a control contract; (iv) P is a shareholder in the insurer and controls (either alone or by an agreement with other shareholders) a majority of the voting rights in the insurer; or (v) P has a participating interest in the insurer and either exercises a dominant influence over it, or P and the insurer are managed on a unified basis.

"Undertaking" in this context will encompass not only a company but also a partnership, unincorporated association or an individual. The definition of "parent undertaking" also contains "look through" provisions in relation to a group of companies so that, in the example previously considered, any parent undertaking of Company B would (if Company B were a parent undertaking of the insurer) also be a parent undertaking of the insurer.

The definition of "parent undertaking" used for the purposes of the FSMA controller provision is substantially the same as the definition used in Part 38 of the U.K. Companies Act 2006. If an entity is a "parent undertaking" for U.K. Companies Act purposes, it will therefore generally be one for FSMA controller purposes too.

An acquiror should also be aware that, for the purposes of determining whether control is being acquired, he will be looked at in the context of persons he is "acting in concert" with. The concept of "acting in concert" was introduced by the Acquisitions Directive and replaces the term "associate" which was defined in section 422 of FSMA. "Acting in concert" is not defined. According to the guidance notes to the Acquisitions Directive, persons are "acting in concert" when each of

them decides to exercise his rights linked to the shares he intends to acquire in accordance with an explicit or implicit agreement made among them. It makes no difference whether this agreement is made in writing or verbally, or whether it becomes apparent only "de facto". Whether the persons acting in concert are otherwise linked with each other is also immaterial. Notification of the voting rights held collectively by these persons will have to be made to the competent authorities either by each of the parties concerned or by one of these parties on behalf of the group of persons acting in concert.

An acquiror who already holds 10% or more of the shares in the Target or its parent undertaking (and has already been approved by the FSA as a controller) will also have to give the FSA formal notice of any increase or decrease in that shareholding (or, indeed, any increase or decrease in any other type of control it has over the insurer or its parent undertaking). The thresholds relevant to the increase or decrease in control are:

- from less than 10% to 10% or more, up to (but less than) 30% in the case of an increase, and from 10% or more to less than 10% in the case of a decrease;
- from less than 20% to 20% or more, up to (but less than) 30% in the case of an increase, and from 20% or more to 10% or more but less than 20% in the case of a decrease;
- from less than 30% to 30% or more, up to (but less than) 50% in the case of an increase, and from 30% or more to 20% or more but less than 30% in the case of a decrease; and
- from less than 50% to 50% or more in the case of an increase, and from 50% or more to 30% or more but less than 50% in the case of a decrease.

Given the wide definitions of control and the circumstances in which an acquisition of control can be triggered, there were concerns that investors in the ordinary course of their business (such as fund management) might find themselves having become controllers

unwittingly through share dealings in the listed parent company of a UK authorized insurer and thereby have committed a criminal offence in the UK by having acquired control at 10% or more without having obtained prior approval from the FSA.

Section 184 of FSMA addresses these concerns to some extent by providing that certain shareholdings can be disregarded, including:

- shares held for the purposes of clearing and settling within a short settlement cycle;
- shares held in certain circumstances by a custodian or nominee acting in that capacity;
- shareholdings of up to 5% held by a market maker;
- shares held by an investment firm as a result of performing underwriting activities in certain circumstances.

In addition, Chapter 11 of the FSA Supervision Manual provides relief for fund managers so as to obviate the need for them to provide notice of all relevant share dealings which would otherwise trigger control situations. Paragraph 11.3.5B of the Supervision Manual provides that:

> *"The FSA may treat as notice given in accordance with ss. 178 and 190(1) of [FSMA] a written notice from an [investment management] firm which contains the following statements:*
>
> *(1) that the firm proposes to acquire and/or dispose of control, on one or more occasions, of any UK domestic firm whose shares or those of its ultimate parent undertaking are, at the time of the acquisition or disposal of control, listed or which are admitted to listing on a designated investment exchange;*
>
> *(2) that any such acquisitions and/or disposals of control will occur only in the course of the firm's business as an investment manager;*
>
> *(3) that the level of control the firm so acquires in the pre-approval period will at all times remain less than 20%; and*

(4) *that the firm will not exercise any influence over the UK domestic firm in which the shares are held, other than by exercising its voting rights as a shareholder or by exercising influence intended to promote generally accepted principles of good corporate governance."*

(2) When Must the Application Be Filed?

The FSA's approval must be sought and granted before an acquisition that triggers the relevant thresholds set out above can proceed.

The relevant provisions of FSMA require notification to be given to the FSA if a "person proposes to take [a step which] would result in his acquiring control over a U.K. authorized person." Merely entering into a stock purchase agreement, which is conditional on the FSA granting its approval to the new controller will not usually constitute a step which requires approval, though closing the transaction clearly is.

However, if an acquiror already holds some shares in the Target insurer (albeit less than 10%) and the stock purchase agreement itself gives the acquiror a substantial amount of control over the Target's affairs in the period between signing and closing (for example, under covenants in the agreement applicable to the conduct of Target's insurance business), it is conceivable that the acquiror could be viewed as having acquired control of the Target when the stock purchase agreement is signed: this should be borne in mind and, if necessary, cleared with the FSA. Similarly, the stock purchase agreement should contain no requirement for the seller to exercise its voting rights in the Target in accordance with the acquiror's instructions in the pre-closing period unless the FSA's approval to the transaction has been obtained prior to signing, as such a provision has the potential to create a "controller" relationship between the acquiror and the Target at the time the agreement is signed.

(3) Form and Content of the Application for Insurance Regulatory Approval

A new controller who has already been approved by the FSA as a controller or is itself an FSA authorized firm or individual must complete the FSA's standard notification form. Any other new controller must complete the (more substantial) corporate or other controller form (as appropriate), which requires more information about the proposed new controller. The type of information required in these forms relates to the entity in which control is being acquired, the nature of the change of control, the name of the new controller, any significant changes proposed to the authorized insurer's business as a result of the change (including financial restructurings) and details of how any acquisition is to be funded. The FSA must be satisfied as to the suitability of the proposed acquirer and the financial soundness of the proposed acquisition, while having regard to the likely influence of the proposed acquirer on the financial undertaking concerned.

The FSA is entitled to require the new controller to provide any additional documents or information that it reasonably requires to consider the application.

Under Chapter 11 of the Supervision Manual, the Target authorized insurer would also be required to submit written notification to the FSA as soon as the Target becomes aware that a person is proposing to take a step that would result in a change in control, or if the event takes place without the knowledge of the Target, within 14 days of the Target becoming aware of the change in control. The notification by the Target must provide its name, the name of the controller or proposed controller (and, if the controller or proposed controller is a body corporate and is not itself an authorized person, the names of its directors and controllers), a description of the proposed event, including the shareholding and voting power of the person concerned, both before and after the proposed event, and any other information of which the FSA would reasonably expect notice, including information

which could have a material impact on any of the approval requirements in FSMA and any relevant supporting documentation.

The Target would be required to be open and cooperative with the FSA, and should discuss with the FSA, at the earliest opportunity, any prospective material changes of which it is aware in the controllers' or proposed controllers' shareholding or voting power. These discussions may and should take place before the formal notification requirements arise. At a minimum, the FSA considers that such discussions should take place before a person (a) enters into any formal agreement in respect of the purchase of shares or a proposed acquisition or merger which would result in a change in control (whether or not the agreement is conditional upon any matter, including the FSA's approval); or (b) purchases share options, warrants or other financial instruments, the exercise of which would result in the person acquiring control or any other change in control. The obligation on the Target applies regardless of whether or not the controller or proposed controller has given or intends to give a notification.

The Target and its controller or proposed controller may discharge the obligation to notify the FSA by submitting a single joint notification containing the information required from the controller or proposed controller and the Target. In such a case, the relevant controllers' or proposed controllers' forms may be used to submit a notification on behalf of both the Target and the controller or proposed controller.

If the acquiror is proposing a change in control over more than one regulated entity within a group, a single notification may be submitted in respect of all those firms. The notification should contain all the required information as if separate notifications had been made, but information and documentation need not be duplicated.

The Supervisory Manual also requires that the Target notify the FSA within 14 days after the proposed change in control has occurred or if the Target has grounds for reasonably believing the event will not occur. The Target may give this notification jointly with the controller.

(4) Time Period for Assessment

The FSA has up to 60 working-days to make a decision following its acknowledgement of receipt of a completed application and may only extend this period once, for a maximum of 20 days, to request further information.

The Acquisitions Directive allows an extension of time for third country acquirers or persons not authorized under the EU Single Market Directives.

In practice, the FSA's decision will almost invariably be given well within the required period, particularly where the new controller is already known to the FSA (for example, it is already the controller of another U.K. authorized financial business).

(5) Standard of Review and Hearing

The Acquisitions Directive requires the FSA to assess the suitability of a proposed acquirer and the financial soundness of a proposed acquisition against the following criteria:

- the reputation of the proposed acquirer;
- the reputation and experience of any person who will direct the business of the Target as a result of the proposed acquisition;
- the financial soundness of the proposed acquirer, in particular in relation to the type of business pursued and envisaged in the Target;
- the ability of the Target to comply on an ongoing basis with the applicable prudential requirements; and
- whether there are substantial grounds to suspect that money laundering or terrorist financing is being or has been committed or attempted.

The FSA may, on completion of the assessment, decide to oppose the proposed acquisition. This can only be done in two cases: if there are reasonable grounds for doing so on the basis of the criteria set out in the Acquisitions Directive; or if the information provided by the proposed acquirer is incomplete.

The FSA may approve an acquisition subject to conditions, and may vary or cancel a condition that it has imposed. However, the FSA may not impose conditions in respect of the level of holding that must be acquired. The FSA must have regard to whether the authorized person will satisfy and continue to satisfy the threshold conditions in relation to all of the regulated activities for which it has or will have permission. An applicant may challenge conditional approval by either applying to the FSA for the conditions to be cancelled or varied, or by referring the matter to the Financial Services and Markets Tribunal. Approvals (whether with or without conditions) remain effective only if the applicant completes the acquisition of the Target before the end of the period of time specified by the FSA in its notice, or if no such period is specified, within one year beginning with the date of the notice confirming approval.

If the FSA proposes to refuse its approval altogether, it may give a formal notice of objection to the acquiror under Section 191A of FSMA. On receipt of such a notice, the acquiror may (again) refer the notice to the Financial Services and Markets Tribunal for review. Under Section 191C of FSMA, the FSA may apply for a court order for the sale of any shares which a person has acquired or continues to hold in contravention of an FSA decision notice.

Neither FSMA nor the FSA's Handbook provide for the approval (or objection) process to be matters of public record or hearing. There is no formal mechanism for the making of representations to the FSA by consumers or other interested parties, but any consumer representations would (no doubt) be considered by the FSA as part of its approval consideration under Section 186 of FSMA.

b. Collaboration with Supervisory Authorities in Other Member States

The Acquisitions Directive requires supervisory authorities in Member States to work in consultation with each other when carrying out the assessment of a proposed change in control if the proposed acquirer is:

- a credit institution, assurance undertaking, insurance undertaking, reinsurance undertaking, investment management firm or UCITS management company authorized in another Member State or in a sector other than that in which the acquisition is proposed;
- the parent undertaking of one of the above types of business; or
- a natural or legal person controlling one of the above types of business.

The supervisory authority for the Target will ultimately decide on the success of the application if it cannot reach an agreement jointly and within the time period with the supervisory authority for the proposed acquirer. However, a decision of the supervisory authority for the Target must indicate any views or reservations expressed by the supervisory authority for the proposed acquirer.

Failure to comply with the FSMA notification requirements is an offence

It is a criminal offence to fail to comply with the notification requirements imposed by sections 178(1) and 191D(1) of FSMA. It is a defense to show that at the time of the alleged offence the person charged had no knowledge of the act or circumstances by virtue of which the duty to notify the FSA arose.

5. OTHER U.K. REGULATORY ISSUES WHICH MAY ARISE ON A STOCK PURCHASE

a. Approved Persons Regime

In addition to the controller approval process for directors of the acquiror outlined above, directors and other officers of the acquiror or its affiliates who are intended to carry out what the FSA has designated "Controlled Functions" within the Target (or any of its FSA authorized subsidiaries) after closing will need to be approved by the FSA for that purpose. The Approved Persons regime is established under section 59 of the FSMA, which obliges authorized firms, including insurers, to obtain FSA approval for individuals carrying out particular functions within the firm.

The types of functions in relation to which approval of the responsible individuals is required divide into a number of categories:

- Governing functions:
  - (i) director function;
  - (ii) non-executive director function;
  - (iii) chief executive function;
  - (iv) partner function;
  - (v) director of unincorporated association function;
  - (vi) small friendly society function
- Required functions:
  - (i) apportionment and oversight function;
  - (ii) compliance oversight function;
  - (iii) money laundering reporting function;
  - (iv) actuarial function;

- Systems and controlled functions:
  - (i) finance function
  - (ii) risk function
  - (iii) internal audit function
- Significant management functions — insurance underwriting, financial resources, etc.
- Customer functions — investment adviser, etc.

The acquiror should consider the possible need for additional approvals from the FSA, if any key personnel within the Target are to be replaced at closing.

The FSA are increasingly interviewing applicants for approved persons status. Such interviews can often last for up to two hours and involve detailed questioning of the applicant by the FSA as to his/her suitability, qualifications and competence to perform the controlled function(s) applied for.

b. Transitional Servicing and Run-Off Arrangements as "Material Outsourcing"

It is possible that the seller will provide the acquiror or the Target (or vice versa) with certain services for a transitional period post-closing. The Target may even be intending to contract out all or part of the administration of its insurance business post-closing. This commonly occurs in areas such as claims handling, particularly if any part of the Target's business is in run-off.

The FSA may regard the former activity (and will certainly view the latter) as a form of outsourcing, even where it is intra-group. The FSA has noted the potential for outsourcing to impact on some of the key principles for authorized firms in its Handbook, with which authorized insurers must comply, notably Principle No. 3: "A firm must take

reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems."

The existence of an administration contract with a third party, even a party authorized in its own right by the FSA, will not necessarily be sufficient to transfer all regulatory responsibility to the service provider and sanctions for failure to meet the FSA's requirements may still fall on the Target, even if the service provider is to blame.

The FSA must be informed of and should confirm its approval to any material outsourcing. "Material" in this context means an outsourcing which has the potential to threaten the Target's compliance with key conditions and principles imposed on it by the FSA. Outsourcing of an entire claims handling process would clearly meet the materiality requirements, whereas outsourcing an employee payroll operation as part of a transitional servicing arrangement would not.

If any new outsourcing is proposed post-closing (even if only for a transitional period), the acquiror and the seller should agree at an early stage whether and when the FSA's approval should be obtained. The FSA will expect to see certain key provisions included in an outsourcing arrangement, such as effective sanctions on the provider for non-performance and meaningful termination rights for the recipient of the services, before it will approve the arrangement.

c. Reform of the UK's Financial Services Regulatory Architecture

The UK's coalition government has embarked upon major reform of the UK's financial services regulatory architecture. It is expected that from January 2013, the FSA will be abolished and three new entities, (i.e. the Financial Policy Committee ("FPC"), the Prudential Regulation Authority ("PRA") and the Financial Conduct Authority ("FCA")) established in its place.

The PRA, which will be a subsidiary of the Bank of England, will be responsible for the authorization and prudential regulation, including

change in control and approved persons approvals, of systemically important firms, such as banks and insurance companies. These firms will be known as dual-regulated firms as the FCA will be their conduct regulator. The PRA's approach to regulation under the new "twin peaks" regulatory structure will be "judgment-led" and proactive rather than the principles-based approach adopted by the FSA.

The FPC will be responsible for macro-prudential regulation of financial services in the UK. The FPC's main objectives will be to identify, monitor and take action to remove or reduce systemic risks, i.e. risks to the stability of the UK financial system as a whole or to a significant part of that system.

CHAPTER FIVE — MERGER CONTROL ISSUES IN INSURANCE M&A

KYRA K. BROMLEY AND TIMOTHY MCIVER DANIEL WIEDMANN[1]

1. MERGER CONTROL ISSUES IN AN INSURANCE M&A TRANSACTION

The purchaser and its advisers will need to consider the merger control aspects of a transaction early in the planning stages. In particular, which jurisdiction's merger control regimes are applicable to the transaction? Will the purchaser be required to suspend the transaction pending merger control clearance? Does the transaction raise substantive antitrust issues? Merger control laws can have a significant impact on the timing of a transaction.

This Chapter covers the rules for antitrust scrutiny of mergers and acquisitions by:

- the U.S. Federal Trade Commission and Department of Justice under the Hart-Scott-Rodino Antitrust Improvements Act of 1976;[2] and
- the European Commission under the EU Merger Regulation.[3]

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[1] Kyra K. Bromley is counsel and Timothy McIver is international counsel with Debevoise & Plimpton LLP. © 2012 Debevoise & Plimpton LLP. The authors are grateful for the contribution of **Daniel Wiedmann**, an associates in the firm's Frankfurt office, in the preparation of this Chapter. All rights reserved. Portions of this Chapter may appear in other materials published by the authors or their colleagues. Portions of this Chapter may appear in other materials published by the authors or their colleagues.

[2] 15 U.S.C. § 18a, as amended.

The purchaser and its advisers will need to consider where the purchaser and the target have business operations (including subsidiaries, assets, branches or sales offices) or make sales in order to determine the list of countries for which a merger control analysis is required. Many jurisdictions (including the European Union) do not require a physical presence for the application of their merger control laws; a requisite level of sales in that jurisdiction is sufficient.

Insurance mergers and acquisitions do not often raise substantive antitrust issues but can do so particularly where specialty markets with few participants are involved.

2. U.S. MERGER CONTROL

In the U.S., mergers and acquisitions are subject to antitrust scrutiny under both federal and state law. Section 7 of the Clayton Act[4] is the primary federal statute governing the legality of mergers and joint ventures, although they also may be subject to antitrust challenges under the Sherman and Federal Trade Commission Acts. With certain exceptions, mergers are subject to the pre-merger reporting requirements of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the "Hart-Scott-Rodino Act").[5]

The McCarran-Ferguson Act[6] provides that certain federal antitrust laws do not apply to the business of insurance to the extent such business is regulated by state law. Although the case law is sparse, available precedent holds that the McCarran-Ferguson Act does not exempt

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3 Council Regulation (EC) No 139/2004.

4 15 U.S.C. § 18.

5 15 U.S.C. § 18a, as amended.

6 15 U.S.C. §§ 1011-1015.

insurance company mergers from the federal antitrust laws.[7] The federal enforcement agencies take the same view and have not hesitated to undertake investigations of insurance company mergers. This position has not been subject to serious challenge in many years, and indeed the U.S. Congress has recently considered proposals to repeal the McCarran-Ferguson exemption.

a. Jurisdictional Thresholds of the Hart-Scott-Rodino Act

Generally, the Hart-Scott-Rodino Act applies to any acquisition by a person of the voting securities,[8] interests in unincorporated entities, or assets of another person if after the transaction, the acquiring person would hold voting securities, non-corporate interests or assets of the acquired person valued at more than $66.0 million (as adjusted) (the "size of transaction" test).

If the acquiring person would hold more than $66.0 million (as adjusted) but not more than $263.8 million (as adjusted) in voting securities, non-corporate interests or assets of the acquired person, a filing is required only if the following "size of persons" test is also met: either the acquiring or acquired person has annual net sales or total assets (worldwide, including its subsidiaries) exceeding $131.9 million (as adjusted) and the other person has sales or assets exceeding $13.2 million (as adjusted).[9] If the size of transaction is more than $263.8

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7 American General Insurance Co. v. FTC, 359 F. Supp. 887 (S. D. Tex. 1973), *aff'd on other grounds*, 496 F. 2d 197 (5th Cir. 1974). *Cf. SEC v. National Securities Inc., 393* U.S. 453 (1969).

8 For purposes of the Hart-Scott-Rodino Act, "voting securities" are those securities which entitle the holder to vote for the election of directors of the issuer.

9 Each of the jurisdictional filing thresholds under the Hart-Scott Rodino Act is subject to annual indexing based on changes in the U.S. Gross National Product.

million, a filing is required regardless of the size of either person, unless an exemption applies.

Generally speaking, acquisitions of assets located outside the U.S. are not subject to the Hart-Scott-Rodino Act so long as those assets (and any other assets acquired from the acquired person within the prior 180 days) do not generate more than $66.0 million in sales to the U.S. Similarly, acquisitions of the voting securities of a non-U.S. issuer are not subject to the Hart-Scott-Rodino Act unless the issuer (including its subsidiaries) has assets located in the U.S. or sales in or into the U.S. exceeding $66.0 million. In addition, a non-U.S. person may acquire less than 50% of the voting securities of a non-U.S. issuer without being subject to the Hart-Scott-Rodino Act, regardless of the issuer's U.S. assets or sales.

The Act exempts acquisitions of voting securities "solely for the purpose of investment … if, as a result of such acquisition, the securities acquired or held do not exceed 10 per centum of the outstanding voting securities of the issuer."[10] Of particular interest to insurers, it also exempts "acquisitions, solely for the purpose of investment, by any … insurance company of (A) voting securities pursuant to a plan of reorganization or dissolution; or (B) assets in the ordinary course of its business."[11] The phrase "solely for the purpose of investment" is interpreted strictly to mean that the acquiring person must not intend to participate in or influence the basic business decisions of the issuer. Soliciting proxies, nominating a candidate for the board of directors, or taking any other actions inconsistent with a passive investment position is generally viewed as negating investment intent. The acquisition of voting securities of a competitor also creates a rebuttable presumption that the voting securities are not held as a passive investor.

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[10] 15 U.S.C. § 18a(c)(9).

[11] 15 U.S.C. § 18a(c)(11).

The analysis of Hart-Scott-Rodino reporting requirements can be complex, especially in non-merger transactions in the insurance industry such as assumption reinsurance arrangements, which are viewed as asset acquisitions and therefore potentially subject to the Act.

b. Federal Trade Commission/Department of Justice Review Procedures

(1) Pre-merger Mandatory Notification

Under the Hart-Scott-Rodino Act, an acquiring insurer may not consummate an acquisition subject to the Act unless both it and the company or other "person" being acquired, or from whom assets are being purchased, have filed reports with the Federal Trade Commission ("FTC") and the Antitrust Division of the Department of Justice ("DOJ"), and the post-filing waiting period has expired.

(2) Time Limits for Decision

The initial waiting period is generally thirty days.[12] The agencies can grant "early termination" if they complete their review before the end of the 30-day period. However, if one of the agencies makes a request for additional documents and information (a "second request"), the waiting period is extended until thirty days following the date of compliance with the request by all parties. In practice, response to a second request usually requires several months.

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12 A waiting period of 15 days applies to all-cash tender offers and certain acquisitions of assets in connection with bankruptcy proceedings.

(3) Sanctions for Failure to Notify or for Implementing a Merger Before Clearance

Any company that fails to comply with the Hart-Scott-Rodino Act is subject to a civil penalty of up to $16,000 for each day during which it is in violation of the reporting requirements. The FTC or DOJ can ask a court to unwind a transaction consummated in breach of the Hart-Scott-Rodino Act.

c. Substantive Appraisal by the FTC/DOJ

Section 7 of the Clayton Act prohibits acquisitions "where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly."[13] The line of commerce or activity affecting commerce is known as the "relevant product market," and section of the country as the "relevant geographic market."

The 2010 Horizontal Merger Guidelines issued by the DOJ and the FTC[14] set forth the analytic framework and standards used by these agencies to determine whether an acquisition is likely to be challenged under Section 7. The Guidelines make clear that "merger analysis does not consist of uniform application of a single methodology" but rather "is a fact-specific process" in which the agencies "apply a range of analytical tools to the reasonably available and reliable evidence to evaluate competitive concerns in a limited period of time."[15] Nevertheless, in assessing the likely outcome of the agencies' review of a proposed transaction, under the Guidelines, advisors to merging

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13 15 U.S.C. § 18.

14 U.S. Department of Justice and the Federal Trade Commission, HORIZONTAL MERGER GUIDELINES (2010) (hereinafter "Merger Guidelines" or "Guidelines").

15 Id. § 1.

insurers should generally (1) define the relevant product market(s), (2) define the relevant geographic market(s), (3) identify the firms to be included in the relevant market(s), (4) calculate market shares and determine their significance, and (5) analyze the potential adverse competitive effects of the merger.

(1) Relevant Product Market

The relevant product market includes all products or services directly competing in the market or reasonably interchangeable with or substitutable for directly competing products. The Guidelines determine which products should be included in the market by first defining the market narrowly and then asking what would happen if a hypothetical monopolist of that product imposed at least a "small but significant and non-transitory" price increase.[16] All substitute products to which the consumer would be likely to turn in response to such an increase would be included in the relevant market.

Thus, a relevant insurance product market could consist of any line of insurance or any insurance product and any reasonable substitutes. The following are examples of insurance products that have been considered relevant product markets: medical malpractice coverage,[17] private health care financing,[18] underwriting fidelity and insurance bonds,[19] title

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16 *Id.* Under Section 4.1.2 of the Merger Guidelines, "most often" the enforcement agencies will consider a 5% increase to be "small but significant and non-transitory."

17 *See* St. Paul Fire & Marine Insurance Co. v. Barry, 438 U.S. 531 (1978).

18 *See* Reazin v. Blue Cross & Blue Shield, Inc., 899 F.2d 951 (10th Cir.), *cert. denied*, 497 U.S. 1005 (1990); Ball Memorial Hospital, Inc. v. Mutual Hospital Insurance, Inc., 784 F.2d 1325 (7th Cir. 1986).

19 *See In re* American General Insurance Co., 81 F.T.C. 1052 (1972).

insurance,[20] worker's compensation insurance,[21] Medicare Advantage health insurance,[22] and individual disability insurance.[23] The precise boundaries of a market are not always easy to demarcate; for example, it may not be clear whether self-insurance should be included in a relevant insurance product market.[24]

(2) Relevant Geographic Market

The geographic market has been described by the Supreme Court as "the area of effective competition … in which the seller operates, and to

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[20] *See* Commander Leasing Co. v. Transamerica Title Insurance Co., 477 F.2d 77 (10th Cir. 1973). Title plant services have also been found to constitute a relevant product market. *See In re* Fidelity National Financial, Inc., No. C-3929 (F.T.C., Complaint filed Feb. 17, 2000); *In re* Commonwealth Land Title Ins. Co., No. C-3835 (F.T.C., Complaint filed Nov. 10, 1998); *In re* LandAmerica Financial Group, Inc., No. C-3808 (F.T.C., Complaint filed May 20, 1998).

[21] *See In re* Worker's Compensation Insurance Antitrust Litigation, 867 F.2d 1552 (8th Cir.), *cert. denied*, 492 U.S. 920 (1989).

[22] *See* U.S. v. UnitedHealth Group Inc., No. 1:08-cv-0322 (D.D.C. Sept. 24, 2008) (available at www.justice.gov/atr/cases/f237600/237613.htm).

[23] *See In re* Provident Companies, Inc. and UNUM Corporation, No. C-3894 (F.T.C., Complaint filed Sept. 3, 1999) (available at http://www.ftc.gov/os/1999/09/unumcomp.htm) (the FTC alleged that the merged entity would control a significant portion of all data relating to individual disability claims, and could restrict competitors' access to credible actuarial information by ceasing to contribute data to databanks maintained by the Society of Actuaries and/or the NAIC; in the Consent Order settling this matter, Provident/UNUM agreed to continue to submit such data).

[24] *Compare* Ball Memorial Hospital, Inc. v. Mutual Hospital Insurance, Inc., 784 F.2d 1325 (7th Cir. 1986), where the court indicated that self-insurance should be included in the market, *with* Reazin v. Blue Cross & Blue Shield, Inc., 663 F. Supp. 1360 (D. Kan. 1987), *aff'd in part and remanded in part*, 899 F.2d 951 (10th Cir.), *cert. denied*, 497 U.S. 1005 (1990), where the issue was left open.

which the purchaser can practicably turn for supplies."[25] The relevant geographic market may be local, national, or international in scope.

The method employed in the Guidelines for defining the geographic market is comparable to that used for determining the product market. "In the absence of price discrimination based on customer location, the Agencies normally define geographic markets based on the locations of suppliers."[26] Beginning with the location of at least one of the merging firms, the agencies will consider what would happen if a hypothetical monopolist of the relevant product imposed at least a small but significant and non-transitory increase in price, but the terms of sale at all other locations remained constant. If the "monopolist" could not sustain the price increase because of the availability of products from other areas, these other areas will be added to the geographic market.

Thus, in defining the relevant geographic market for insurance products, the issue is whether the insureds in a particular area could readily switch from insurers within that region to others outside it. Whether the market is local, national, or international will turn on the facts of the particular case, including such factors as regulatory restrictions on out-of-state competition and the resources or sophistication of the purchasers.[27]

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[25] United States v. Philadelphia National Bank, 374 U.S. 321, 359 (1963).

[26] Merger Guidelines, *supra* note 10, § 4.2.

[27] *Compare* United States v. Aetna Inc. and The Prudential Ins. Co. of America, No. 3-99 CV 1398-H, 1999 WL 1419046 (N.D. Tex. Dec. 7, 1999), where the market for HMO-based point-of-service health plans was alleged to be limited to Houston and Dallas, Texas, *with In re* American General Insurance Co., 81 F.T.C. 1052 (1972), where the market in underwriting fidelity and surety bonds was alleged to be national.

(3) Firms Included in the Market

The third step in the analysis, after defining each of the relevant markets, is determining the firms to be included in the market. Under the Guidelines, the relevant market includes not only firms currently selling in the market or committed to entering the market but also "rapid entrants" – other firms "that would very likely provide rapid supply responses with direct competitive impact in the event of a [small but significant and non-transitory increase in price], without incurring significant sunk costs."[28]

Under this analysis, any relevant insurance market would include not only those companies selling a particular type of insurance in a particular geographic area, but also all those firms that could readily, and would be likely to, offer the product in that area if the firms already in the market attempted to exercise market power by raising prices above competitive levels. However, the increasing sophistication of many insurance products, among other factors, may call into question some earlier pronouncements on the ease of supply-side responses.[29]

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[28] Merger Guidelines, *supra* note 10, § 5.1.

[29] The DOJ at one time reported that it had conducted a limited survey in which it "found strong indications that [property-casualty] insurers normally can, quickly and easily, acquire the necessary licenses and expertise to either begin selling their existing lines of insurance in new states or to provide new lines in the states in which they are already licensed… . These facts suggest that, even though at any one time only a small number of firms may be observed writing a specific line in a particular state, all firms in the property-casualty industry in the United States should be included in the relevant market for any particular type of property-casualty insurance." *See* U.S. Department of Justice, THE CRISIS IN PROPERTY CASUALTY INSURANCE, at 8 (Mar. 1987), attached as an Appendix to Tort Policy Working Group, AN UPDATE ON THE LIABILITY CRISIS (Mar. 1987).

(4) Market Shares and Their Significance

The next step under the Guidelines is to determine the market shares of the participants and measure their effect on concentration under the Herfindahl-Hirschman Index (HHI).[30] If the postmerger HHI is below 1,500, the Guidelines state that the merger is unlikely to be challenged because "[m]ergers resulting in unconcentrated markets are unlikely to have adverse competitive effects and ordinarily require no further analysis."[31] Many insurance markets fall within this range, although some markets, particularly specialty or localized markets, may not.

A market with a postmerger HHI above 2,500 is considered to be highly concentrated. Under the Guidelines, in such a market, a merger producing an increase in the HHI of more than 200 is presumed "likely to enhance market power."[32]

(5) Effect of Acquisition on Competition

An HHI-based presumption under the Guidelines that an acquisition is likely to create or enhance market power may be overcome by a

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30 The HHI is an index of market concentration calculated by summing the squares of the market shares of all the firms in the market. For example, a market with ten firms each having a 10% share would have an HHI of 1000. The competitive effect of a merger under this formula is determined by calculating what the HHI would be if the merger is consummated (the "postmerger HHI") and the increase in the HHI resulting from the merger (the "delta"). Thus, if there are four firms in the market, each with a 25% share, and two of these merge, the postmerger HHI would be 3,750 and the increase 1,250. If there are twenty firms in the market, each with a 5% share, and two of them merge, the postmerger HHI would be 550 and the delta 50. The first merger would probably be closely scrutinized; the second would almost certainly not be.

31 Merger Guidelines, *supra* note 10, § 5.3.

32 *Id.*

showing that in fact it will not be likely to produce anticompetitive effects. The Guidelines identify a number of factors, such as ease of entry, that should be considered in determining whether this presumption of illegality may be overcome.

Most insurance mergers should survive scrutiny under Section 7 of the Clayton Act because most insurance markets are unconcentrated. However, because merger analysis is dependent upon market definition and an analysis of the probable effect on competition, an acquisition of an actual or potential competitor should be carefully reviewed to determine if it might present antitrust risk, particularly where the acquisition involves a market small in geographic scope, involves a specialty line of insurance, or relates to a market undergoing significant consolidation.

d. State Regulation of Insurance Mergers

In addition to federal antitrust laws applicable to mergers, every state has enacted either a version of the NAIC Insurance Holding Company System Regulatory Act (the "Model Act") or a statute with comparable provisions.[33] The Model Act covers certain acquisitions of control and mergers of both insurance companies domiciled in a particular state and foreign (*i.e.*, nondomiciliary) companies. For acquisitions of control and mergers of domestic insurers, the Model Act provides for prior approval by the domiciliary state insurance authority. For acquisitions of control and mergers of nondomiciliary insurers authorized to do business in a state, the Model Act provides for prior notification to the state's insurance regulatory authority of overlaps and concentration levels in

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33 The Model Act was adopted by the National Association of Insurance Commissioners in 1969 and has been amended on several occasions, most recently in 2001. *See* N.A.I.C., III MODEL LAWS, REGULATIONS AND GUIDELINES 440 (2004).

the merging insurers' lines of business, and observance of a 30-day waiting period (60 days in the State of Washington).[34]

3. EU MERGER CONTROL

In the European Union ("EU") there are two levels of merger control in place. The European Commission (the "Commission") has, as a general rule, exclusive jurisdiction to review concentrations with a Community dimension. Mergers that do not qualify as a concentration or that do not have a Community dimension may be reviewed by the individual national competition authorities ("NCAs") of the member states. This allocation of cases between the Commission and the NCAs is qualified by a system of referrals[35]. The national level merger control rules in the EU and EFTA member states are outside the scope of the present chapter.

The primary piece of legislation governing the Commission's review of mergers is the EU Merger Regulation, which applies in the 27 EU

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34 *Id.* § 3.1. This section was originally designated as the NAIC Model Acquisition and Merger Law. It was added to the Model Act in 1980. *See id.* at 440-28. As of August 2008, twenty-three states and the District of Colombia had adopted Section 3.1 of the Model Act. Exceptions apply. *See supra* Section 2.b(2) of Chapter Four.

35 The EU Merger Regulation allows the merging parties to request that their transaction be referred from the member states to the Commission, or vice versa. For a referral to the Commission, the merger needs to be subject to merger control review in at least three member states. The Commission or the relevant NCAs can veto a referral. In addition, a member state may request the Commission to review a merger for which the Commission does not have jurisdiction but which affects trade between member states and threatens to significantly affect competition within that member state. Alternatively, a member state may request the Commission to refer all or the relevant part of a merger for which the Commission has jurisdiction for review by the NCA of such member state (rather than the Commission) if such merger threatens to significantly affect competition within a "distinct" market in that member state.

member states[36] and three EFTA states (Iceland, Liechtenstein and Norway).

a. Jurisdictional Requirements of the EU Merger Regulation

(1) Concentrations

The EU Merger Regulation applies to "concentrations" which have a "Community dimension". A concentration is broadly defined as a merger of two or more previously independent undertakings, or the acquisition of direct or indirect control by one or more undertakings of the whole or part of another undertaking, which leads to a lasting change in the structure of the undertakings concerned. The creation of a full function joint venture also constitutes a concentration.

The definition of control requires that one or more parties acquire the possibility of exercising "decisive influence" over an undertaking. Decisive influence is decided on a case by case basis; more than 50% of the voting rights clearly affords decisive influence and veto rights over strategic business decisions (budget, business plan, appointments of senior managers) also can constitute decisive influence. In certain circumstances the acquisition of a shareholding of less than 25% might be found to afford decisive influence.

(2) Community Dimension

A concentration will have a "Community dimension" if the turnover of the undertakings concerned exceeds one of two quantitative thresholds.

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[36] The EU member states are Austria, Belgium, Bulgaria, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the UK.

Threshold 1

- The combined aggregate worldwide turnover of all the undertakings concerned[37] is more than €5,000 million;
- the aggregate EU-wide turnover of each of at least two of the undertakings concerned is more than €250 million; and
- unless each of the undertakings concerned achieves more than two-thirds of its aggregate EU-wide turnover within one and the same member state.

Threshold 2

- The combined aggregate worldwide turnover of all the undertakings concerned is more than €2,500 million;
- in each of at least three EU member states, the combined aggregate turnover of all the undertakings concerned is more than €100 million;
- in each of at least three of these member states included above, the aggregate turnover of each of at least two of the undertakings concerned is more than €25 million;
- the aggregate EU-wide turnover of each of at least two of the undertakings concerned is more than €100 million; and
- unless each of the undertakings concerned achieves more than two-thirds of its aggregate EU-wide turnover within one and the same member state.

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[37] The "undertakings concerned" are: each of the merging companies in the case of a merger; the bidder and the target in the case of a public offer; the purchaser and the target in the case of the private acquisition of sole control; and each undertaking acquiring joint control of a target, as well as the target.

(3) Calculation of Turnover

Under the EU Merger Regulation, the general rule is that "turnover" is the revenue derived by the undertakings concerned in the preceding financial year from the sale of products and/or the provision of services after the deduction of sales rebates and of value added tax and other taxes directly related to turnover. Turnover is calculated at an aggregate group level for each of the undertakings concerned. [38] Intra-group turnover is not to be taken into account.

For insurance companies, the EU Merger Regulation specifies that the value of gross premiums written is to be used instead of turnover.[39] In other words, one uses the value of gross premiums written, after deduction of taxes and parafiscal contributions or levies charged by reference to the amounts of individual premiums or the total volume of premiums. Gross premiums written are calculated as all amounts received and receivable in respect of insurance contracts issued by or on behalf of the insurance undertaking, including premiums received on outgoing reinsurance.[40] (No adjustment is made for any amounts paid or payable by the insurance undertaking to obtain reinsurance cover.)

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[38] A group comprises all undertakings in respect of which the ultimate parent company, directly or indirectly, alone or with one or more of the other group undertakings:

- owns more than half the capital or business assets; or
- has the power to exercise more than half the voting rights; or
- has the power to appoint more than half the members of the supervisory board, the administrative board or bodies legally representing the undertakings; or
- has the right to manage the undertakings' affairs.

[39] *See* EU Merger Regulation, Article 5(3)(b).

[40] Premiums relate not only to new insurance contracts entered into during an accounting year but also to all premiums related to contracts made in previous years which remain in force during the relevant period.

One also includes turnover generated by any non-insurance entities controlled by the insurance company.[41]

Insurance income (premiums written) should be geographically allocated based on the location of the persons from whom the premiums have been received.[42]

b. European Commission Review Procedure

(1) Pre-merger Compulsory Notification

Where a notification is required under the EU Merger Regulation, notification is compulsory and must be made to the Commission (and in general Commission clearance must be obtained) prior to completion of the acquisition. Notification may be made as soon as there is a good faith intention to conclude an agreement (as evidenced, for example, by a letter of intent) or, in the case of a public offer, where it has been publicly announced. The obligation to notify is on the person acquiring control.

The transaction cannot be completed until the Commission has given a clearance decision.[43] If the notification is in respect of a public offer,

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41 Revenues received by an insurance undertaking from pure financial investments (in other words, investments by the insurance undertaking where it does not have control of the undertaking where its investment is made) are not included in the calculation of turnover. However, where the insurance undertaking does have the right to control the undertaking where its investment is made (as determined pursuant to the criteria set forth in EU Merger Regulation Article 5(4)), the turnover of such undertaking is to be added to the premiums written of the insurance undertaking. (See paragraph 216 of the Commission Consolidated Jurisdictional Notice.)

42 *See* EU Merger Regulation, Article 5(3)(b).

the offer may proceed provided that (i) the concentration is notified to the Commission without delay, and (ii) the offeror does not exercise the voting rights attached to the shares until the Commission has issued its clearance decision, or does so pursuant to a derogation granted by the Commission only to maintain the full value of its investments.

Notification is made on Form CO (or in cases which meet certain criteria intended to identify non-complex concentrations, on the Short Form). The Form CO requires the filing party to provide a considerable amount of information, including a more detailed competitive analysis than the Hart-Scott-Rodino Act filing. The Short Form is substantially less burdensome that the full Form CO, but still requires detailed information on any horizontal overlaps and any vertically related markets.

(2) Time Limits for Decisions

The timetable for the Commission's Phase I investigation of a transaction is 25 Commission working-days from the first working day following the date of receipt of the notification or, if the information supplied is incomplete, from the first working day following the receipt of the complete information. This period can be extended to 35 working-days in certain circumstances. The Commission must issue its decision within this time period, or the concentration will be deemed cleared.[44] If at the end of Phase I the Commission decides that the transaction raises serious doubts as to its compatibility with the common market, it will issue a decision to that effect and an in-depth

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43 EU Merger Regulation Article 7(3) states that parties may seek a derogation allowing the closing to occur prior to receipt of the Commission's clearance. In practice, such derogations are rarely granted.

44 The notion of a deemed clearance due to the Commission's omission to issue a decision before the end of the review period is purely theoretical. In practice, the Commission always issues its decision prior to the expiry of the review period.

"Phase II" investigation will be initiated. The duration of the Phase II investigation is 90 Commission working-days (which in certain circumstances can be extended up to a maximum of 125 working-days) from the date of initiation of the Phase II investigation.

(3) Sanctions for Failure to Notify or for Implementing a Merger Before Clearance

Fines of up to 10% of the aggregate worldwide group turnover of the undertaking concerned may be imposed for failure to notify a transaction, implementation of a transaction prior to a clearance decision, or failure to comply with an obligation attached to a Commission clearance decision. If a concentration has already been implemented and it is found to be incompatible with the common market, the Commission may require the undertakings concerned to dissolve the merger or to dispose of the shares or assets acquired.

c. Substantive Appraisal of Concentrations by the Commission

(1) The Test Applied

The Commission must make a prospective determination as to whether a transaction will "significantly impede effective competition in the EU or in a substantial part of it, in particular as a result of the creation or strengthening of a dominant position".[45] In addition, with respect to joint ventures, the Commission will also assess whether the creation of

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45 A dominant position has been defined as "a situation where one or more undertakings wield economic power which would enable them to prevent effective competition from being maintained in the relevant market by giving them the opportunity to act to a considerable extent independently of their competitors, their customers and ultimately of consumers." *See* Case T-102/96, Gencor v Commission.

the joint venture may have as its object or effect the coordination of the competitive behavior of the parents that remain independent.[46]

(2) Market Analysis

The Commission will generally consider the following issues:

- Possible horizontal unilateral effects arising from a merger between parties active on the same product and geographic markets.
- The potential for coordinated effects, which may arise if a horizontal merger may result in or reinforce a market structure that could be conducive to explicit or tacit collusion.
- The parties' activities in upstream or downstream markets (*i.e.*, any vertical relationships).
- The conglomerate effects of the merger (for example, tying, bundling and portfolio effects) whereby one party uses its strength in one market to achieve anti-competitive effects in another market.

The Form CO will contain information on the relevant product and geographic markets of the parties' activities and where the parties have an appreciable market share the Form CO will include detailed information on the "affected markets."[47] In its review, the Commission

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[46] In *Skandia/Storebrand/Pohjola*, the Commission examined whether the fact that the joint venture would use its parents' distribution networks would give the parents an opportunity to co-ordinate their competitive behaviour in the life insurance market. However, given that the parties were hardly active on each other's life insurance markets, the Commission did not identify such risks. Case IV/JV.21 — Skandia/Storebrand/Pohjola.

[47] "Affected markets" include (i) markets where there is a horizontal overlap and the parties' combined market shares is 15% or more at a national or EU level; and (ii) markets having a vertical relationship where the

will analyze the definition of the relevant product markets and relevant geographic markets, the market power of the parties and the competitive constraints facing the merged entity in order to assess the risk of a significant effect on competition.

In a Form CO for a transaction involving horizontal overlaps and/or vertical relationships in the insurance industry, the Commission often requires the parties to provide information based both on a narrow definition and a broad definition of the relevant product markets and relevant geographic markets.

(3) The Relevant Product Market

The Commission's decisions in the insurance and reinsurance sector contain useful insights into its likely definition of the relevant product market, although each case will turn on its own facts and circumstances.[48] (In many clearance decisions, the Commission leaves open the definition of the relevant market since it is not necessary to reach a conclusion in order to clear the transaction in question.) Set out below is a summary of the Commission's views on the relevant product markets in the insurance and reinsurance sector as derived from past Commission decisions.

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individual or combined market share of the parties is 25% or more at either the upstream or downstream level, regardless of whether there is any existing supply relationship between the parties.

48 The relevant product market comprises all products and/or services regarded as interchangeable or substitutable by the consumer, by reason of the products' and/or services' characteristics, prices and intended use. See paragraph 7, Commission Notice on the definition of the relevant market.

- Life insurance, non-life insurance and reinsurance are considered to belong to different product markets.[49]
- For life insurance, the Commission has observed that from the demand side the market can be divided into three separate segments: protection products, pension products and savings and investment products (and perhaps further divided into individual and group pension and protection products), but has left open the issue of whether those segments might constitute distinct relevant product markets.[50] The Commission also considered pension and investment products together, but in a separate class from pure protection products.[51] In recent cases, the Commission has distinguished between group life insurance products and individual life insurance.[52]
- For non-life insurance, the Commission has observed that, from the demand side, the market could be divided into as many product markets as there are different kinds of risks covered (such as aerospace, marine, commercial and real estate) since their characteristics, premiums and purposes are distinct and there is typically no substitutability for the consumer between the different risks insured.[53] The Commission has also

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49 *See inter alia* Cases No. COMP/M.4284 - AXA/Winterthur; COMP/M.6053 - CVC/Apollo/Brit Insurance; COMP/M. 6217 Bâloise Holding / Nateus / Nateus Life.

50 *See inter alia* Case No COMP/M.4047 – Aviva/Ark life.

51 *See* Cases No. COMP/M.5075 Vienna Insurance Group/EBV; COMP/M.5728 Crédit Agricole/Société Générale Asset Management; COMP/M.5384 BNP Paribas / Fortis.

52 *See inter alia* Case No COMP/M.5031 – ACE/CICA.

53 The Commission has generally considered a distinction between the following segments: (i) accident and sickness; (ii) motor vehicle; (iii) property; (iv) marine, aviation and transport ("MAT"); (v) liability; (vi) credit and suretyship; and (vii) travel. *See inter alia* Cases No.

found that, from a supply-side perspective, the conditions for providing non-life insurance of different risk types are quite similar and most large insurance companies are active in several risk types. So far, the Commission has left open the issue of whether these different types of non-life insurance are part of the same product market.[54] The Commission has also observed that the non-life insurance market might be divided into distinct markets for non-life insurance for individuals and non-life insurance for companies.[55]

- The Commission has observed that the reinsurance sector could perhaps be subdivided into two markets: life and non-life[56], and that, within the non-life segment, perhaps a segmentation according to the class of risk covered should be considered.[57]
- In the insurance distribution sector, the Commission has drawn a distinction between the distribution of life and non-life insurance, as different providers tend to be involved and the distribution of life insurance in Europe is regulated separately from other types of insurance. The Commission has left open whether the market can be further sub-divided by distribution channels (brokers and other insurance distributors), by business sector (for example, marine, aviation and space, energy), by type

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COMP/M.4284 AXA/Winterthur; COMP/M.4701 Generali/PPF Insurance Business.

54 *See inter alia* Cases IV/M.862 — AXA/UAP and IV/M.2676 — Sampo/Varma Sampo/IF Holding/JV.

55 *See* Cases No COMP/M.2676 – Sampo/Varma Sampo/IF Holding/JV; COMP/M.6521 – Talanx International/Meiji Yasuda Life Insurance/Warta.

56 *See inter alia* Case IV/M.1306 — Berkshire Hathaway/General Re.

57 *See inter alia* Cases No. COMP/M.5925 MetLife / Alico / Delam; COMP/M.5083, Groupama / OTP Garancia; COMP/M.6053 CVC / Apollo / Brit Insurance.

of risk insured (for example, directors' and officers' liability) or by client size (consumers, commercial clients and large corporate clients).[58]

- In the reinsurance distribution sector, the Commission has left open whether the relevant market is that for all reinsurance distribution (*i.e.*, reinsurance broking and direct reinsurance), or whether the two channels should be viewed as separate product markets.[59]

- For insurance underwriting and managing services, the Commission has identified a relevant product market, distinct from either insurance or reinsurance, which includes underwriting and managing services provided to both insurers and reinsurers, and observed that there might exist a separate product market for underwriting and managing services for aerospace insurance and reinsurance, but left the issue open.[60]

(4) The Relevant Geographic Market

Set forth below is a summary of the Commission's views on the relevant geographic market for the insurance and reinsurance sector as derived from its past decisions:[61]

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58 *See* Case IV/M.1307 — Marsh & McLennon/Sedgwick.

59 *See id.*

60 *See* Case No COMP/M.3035 – Berkshire Hathaway/Converium/GAUM JV.

61 The relevant geographic market is the area in which the undertakings concerned are involved in the supply and demand of products or services, in which the conditions of competition are sufficiently homogenous and which can be distinguished from neighboring areas because the conditions of competition are appreciably different in those areas. *See* paragraph 8, European Commission Notice on the definition of the relevant market.

- The Commission often considers the possibility that the geographic market for life insurance may be broader than national but thus far has concluded that this market is national in scope.[62]
- The Commission has generally considered the relevant geographic markets for the different types of non-life insurance to be national,[63] with the exception of: (i) large commercial risks, such as the insurance of aerospace risks, which are considered most likely to be at least EEA-wide in scope; and (ii) MAT insurance, which is considered likely to be wider than national for large/ multinational corporate customers and large risk insurance respectively.[64] However, the Commission has not found it necessary to conclude on the exact scope of the geographic market for non-life insurance and has left the definition open.
- For reinsurance, the Commission considers the relevant market to be worldwide.[65]
- For insurance distribution, the Commission has not taken a position on the geographic market, but its starting point has been to consider a national market.[66]
- The Commission has found reinsurance distribution to be a worldwide market.[67]

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62 *See inter alia* Cases IV/M.862 — AXA/UAP; IV/M.2676 — Sampo/Varma Sampo/IF Holding/JV; COMP/M.5075 Vienna Insurance Group/EBV; COMP/M.5057 Aviva/UBI Vita

63 See inter alia Case COMP/M.4284 AXA/Winterthur.

64 See inter alia Case COMP/M.5010 Berkshire Hathaway / Munich RE / GAUM.

65 *See inter alia* Cases IV/M.1306 — Berkshire Hathaway/General Re; COMP/M.5925 MetLife / Alico / Delam.

66 *See* Case IV/M.1307 — Marsh & McLennan/Sedgwick.

- For underwriting and managing services for insurers and reinsurers, the Commission has considered the geographic market to be either EEA-wide or worldwide.[68]
- For marine and transport insurance, the Commission has observed that the geographic market has been described as international, but left the issue open.[69]

Where the parties to a transaction are both involved in insurance or reinsurance activities, a careful analysis of the relevant product and geographic markets will need to be included in the Form CO. The Commission frequently requires information based on both wider and narrower market definitions, including in respect of product and geographic markets which may not appear to be affected markets.

(5) Compatibility with the Common Market

When conducting its substantive assessment, the Commission will primarily consider market shares and concentration levels as first indicators of market structure and of the competitive importance of both the merging parties and their competitors.

A combined post-merger market share below 25% usually will be presumed not liable to impede effective competition.[70] A share of 50%

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67 *See id.*

68 *See* Case No COMP/M.3035 – Berkshire Hathaway/Converium/GAUM JV.

69 *See* Case No COMP/M.3556 – Fortis/BCP.

70 See Recital (32) to the EU Merger Regulation. In *AXA/UAP*, the Commission considered that a transaction that would lead to market shares in the range of 30% on several different non-life insurance product markets by parties who were already the number one players in their domestic market, combined with the relatively small market positions held by their competitors, might under certain conditions create the risk that a

or more may be strong prima facie evidence of a dominant position.[71] A market share of 70% or more is considered as conclusive evidence of dominance.[72]

The Commission often applies HHI as a relevant measure of concentration levels. The Commission has stated that a horizontal merger with a post-merger HHI[73] below 1000 is unlikely to raise horizontal competition concerns.[74] Moreover, the Commission's view is that a merger with a post merger-HHI between 1000 and 2000 and a delta below 250, or with a post-merger HHI above 2000 and a delta below 150, is unlikely to lead to horizontal competition concerns unless special factors exist.[75]

With respect to non-horizontal mergers, the Commission considers that competition issues are unlikely where the post-merger market share of the new entity in each relevant market is below 30% and the post-merger HHI is below 2000.[76]

A high market share of the merged entity may lead to a Phase II investigation, but it will not necessarily lead to a finding that the merger is incompatible with the common market. The Commission will also consider other important factors such as whether the parties are close

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dominant position is created by the merger. Case IV/M.862 – AXA/UAP.

71 *See* Guidelines on the assessment of horizontal mergers, paragraphs 17 and 18. It is a distinct question whether a dominant position is created or strengthened as a result of the merger.

72 Case 85/76, *Hoffmann-La Roche* [1979] ECR 461.

73 *See* Section 2.c(4) above for information on the Herfindahl-Hirschman Index.

74 *See* Guidelines on the assessment of horizontal mergers, paragraph 19.

75 *See* Guidelines on the assessment of horizontal mergers, paragraph 20.

76 *See* Guidelines on the assessment of non-horizontal mergers, paragraph 25

competitors, evidence of potential new market entry or expansion and the existence of any barriers to such entry or expansion, the constraint imposed by actual or potential competition and the countervailing power of suppliers and customers.

Finally, where a concentration gives rise to substantive competition issues, the parties can offer undertakings both at Phase I and during Phase II to address the Commission's concerns.[77]

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[77] In *Allianz/AGF*, the Commission identified concerns in the delcredere credit insurance segment of the non-life insurance business. Despite the parties' high market shares it was not the horizontal overlap as such that presented a problem. The Commission was concerned about AGF's structural and personal links with Coface, one of the main competitors. It therefore only cleared the transaction after AGF had undertaken to divest itself entirely of its stake in and to cut any personal links with Coface. Case IV/M.1082 – Allianz/AGF.

CHAPTER SIX — SELECTED TAX ISSUES IN INSURANCE M&A

SETH L. ROSEN AND RICHARD WARD[1]

This Chapter discusses certain U.S. and U.K. tax issues which commonly arise in the context of M&A transactions involving insurance companies. The U.S. and U.K. tax rules applicable to the insurance business, particularly to the life business, are extraordinarily complex and in both cases will raise significant due diligence issues. By way of example, we have highlighted the special concerns in the U.S. related to the tax status of life insurance products. Our main discussion, however, focuses on the factors which in both jurisdictions have a significant influence on how an M&A transaction involving a U.S. or U.K. Target is structured. In the U.S., there are special rules applicable to the inclusion of life insurance companies in consolidated federal income tax returns with affiliates that are not life insurance companies and to the treatment of purchases of insurance companies as actual or deemed asset purchases, which provide the main focal point for discussion. The U.K. tax code does not have similar rules specifically applicable to insurance companies which affect how transactions are structured, with the result that our discussion of U.K. considerations is more generic.

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1. U.K. TAX STRUCTURING CONSIDERATIONS

The acquisition structure for a U.K. insurance company will generally be influenced by the following tax objectives:

- Minimizing the immediate tax costs of the acquisition.
- Ensuring that if securities are issued to Target shareholders by the Acquiror, Target shareholders do not recognize immediate tax liabilities.
- Allowing costs of acquisition debt and/or shareholder debt to be offset against profits of the Target group.
- Managing the Target group's effective tax rate following the acquisition.

a. Immediate Tax Costs of Acquisition

One potentially significant tax cost in acquisitions of U.K. companies is stamp duty, which is charged at the rate of ½% of the value of the consideration paid for the shares (although stamp duty may not be payable if the shares are held under an ADR program). Since stamp duty is generally only payable in relation to transfers of shares in companies that are incorporated in the United Kingdom, there may be opportunities to avoid stamp duty if the Target is owned within a corporate group and the Buyer acquires shares of a non-U.K. company, for example if the U.K. Target is owned by a non-U.K. holding company from which any non-Target assets have been removed prior to its acquisition. There is limited scope, however, for restructuring the ownership of the Target within the Seller's group prior to the sale of Target in order to enable an appropriate non-U.K. holding company to be sold unless the restructuring is effected well in advance of the sale, despite the fact that transfers within a group are generally free from stamp duty.

In the context of public M&A transactions, where stamp duty costs may be potentially very significant, stamp duty is often avoided if the acquisition is structured as a "scheme of arrangement" falling within Section 895 of the Companies Act 2006. A scheme of arrangement in this context generally involves a tripartite arrangement under which the existing shares in the Target held by the Target shareholders are cancelled, on terms that the Target issues new shares to the Acquiror and the Acquiror pays the consideration direct to the Target shareholders. The scheme of arrangement therefore does not involve the transfer of the existing Target shares, and for this reason stamp duty is not payable. A scheme of arrangement is a more cumbersome procedure than a tender offer for Target shares, since it involves the consent of the courts (whose primary role is to protect the interests of the Target's creditors). However, there are some other potential advantages to the use of a scheme of arrangement in a public M&A context, including a lower threshold for squeezing out minority shareholders. It is therefore in common use currently in a public M&A context.

Other immediate tax costs which require evaluation will arise where the Target is being sold by a corporate Seller. As a general proposition, assets may be transferred within a U.K. tax group at cost for U.K. tax purposes, so that no immediate tax charge arises. However, where the transferee leaves the group within six years of the intra-group transfer, a charge to tax may arise in respect of the unrealized gain on the relevant assets as of the date of the intra-group transfer. Prior to April 1, 2011, any such "degrouping charge" would fall on the transferee, although it was possible for the charge to be transferred to another group company through a statutory election procedure. With effect from April 1, 2011, the degrouping charge will in many cases fall on the transferor. In other situations, including in the case of Lloyd's syndicate capacity rights, the old regime will continue to apply and such degrouping exposures will need to be dealt with by use of the election procedure or indemnification, or both.

b. "Roll-Over" Relief for Target Shareholders

(1) Considerations for Individual Target Shareholders

Generally, if the Acquiror issues shares or debt securities to the Target shareholders in exchange for their shares in the Target (including under a tripartite "scheme of arrangement" described in Section 1.a. of this Chapter), Target shareholders will not be required to recognize any immediate taxable gain because the exchange should fall within the tax-free reorganization provisions in the U.K. capital gains tax code. The operation of the reorganization provisions is, however, subject to anti-avoidance provisions in relation to Target shareholders who own more than 5% of any class of its share capital, which deny reorganization treatment where the transaction is primarily motivated by tax avoidance considerations. Although these anti-avoidance provisions will generally not be in point where the Sellers and Acquiror are not connected parties, it is normal, particularly in a public M&A context, to take advantage of an advance ruling procedure under which the U.K. tax authorities are required to confirm whether the anti-avoidance provisions are applicable to the transaction.

Although the reorganization provisions are intended to apply to most types of share exchange transactions involving a change of control, they are somewhat inflexible in certain respects. In particular, they require the issuer of the shares or securities to be the same person that acquires the shares in the Target except (somewhat irrationally) in the case of a "scheme of arrangement." This means that, if the Acquiror wishes the Target to be held by one of its subsidiaries (for example, an intermediate U.K. holding company), the Acquiror must first acquire the Target shares and transfer the Target shares down to the subsidiary, rather than the Target shares being directly acquired by the subsidiary. The stamp duty costs of the transaction should not be increased because the Target shares are transferred twice, however, because relief from stamp duty should be available on the transfer of the Target shares by the Acquiror to its subsidiary.

If the consideration paid by the Acquiror takes the form of a cash payment, including a deferred cash payment under earn-out arrangements, U.K. Target shareholders would be exposed to immediate recognition of gain for tax purposes since the transaction will fall outside the reorganization provisions, to the extent of the cash consideration. For this reason, earn-out arrangements are often structured so that the earn-out payments take the form of the issue of a debt security, albeit with a relatively short term, in order to secure reorganization treatment for the earn-out. This enables the recognition of taxable gains to be deferred until cash is actually received by the Target shareholders.

(2) Considerations for U.K. Corporate Seller

The rules on the taxation of capital gains applicable to the sale or other disposition of shares by companies within the charge to U.K. corporation tax (which covers companies resident in the U.K. and those which have a taxable presence in the form of a permanent establishment through which active trading activities are undertaken) differ in a number of important respects from the rules applicable to the taxation of individuals.

Critically, exemption from tax is conferred by a form of participation exemption known as the "substantial shareholding exemption" (or "SSE") for a company whose activities (and those of the group of which it is a member) principally comprise active trading, rather than investment, activities. Such a company's interest in another such company generally benefits from the "SSE" exemption provided that an interest of at least 10% has been held for at least one year. The rules are extremely complex, particularly when compared with similar exemptions found elsewhere within the EU. In addition, where the shareholding is held as an asset of an insurance company's long-term insurance fund, the 10% requirement is increased to 30%.

One of the effects of the "SSE" rules is that the tax treatment of earn-out consideration may not attract full exemption from tax. Where this is

the case, the seller will acquire tax basis in the earn-out right (whether it is structured as a right to a cash payment or a security) equal to the market value of the right at the time of the sale of the Target. Gain or loss will be recognized (taxable at the normal corporation tax rates – the main rate is currently 26%) to the extent the amount of the earn-out actually paid differs from this value, irrespective of whether the sale of the shareholding qualified for the SSE.

This unfavorable treatment applies where the amount of the earn-out is not ascertainable at the time of the sale (even if subject to a financial cap), but not where the amount of the earn-out is ascertainable at that time. For this reason, where the seller is a U.K. corporate seller, the earn-out may need to be carefully structured in order to ensure that the amount payable is ascertainable, and therefore the "SSE" applies in relation to its receipt, even if part of that amount needs to be clawed back by the purchaser by some other mechanism in circumstances where the earn-out does not fully vest from a commercial perspective.

c. Acquisition Debt

One of the tax objectives of the Acquiror may be to reduce the taxable profits of the Target group to the maximum extent possible by pushing down acquisition debt to the Target group, and perhaps also supplementing the interest costs of such acquisition debt by financing the Target with shareholder loans. Regulatory capital rules will have a significant influence on the extent to which this is possible since it is not generally possible for the more senior tiers of regulatory capital to be structured in a way that produces tax deductible interest for shareholder funding.

From a U.K. tax perspective, interest costs of acquisition debt and shareholder debt are capable of being offset against Target's profits provided that the borrower and the Target are members of the same U.K. tax group. Group membership is, however, generally permitted only for companies that are subject to U.K. corporation tax (which generally is restricted to U.K. resident companies). Therefore, if the

Target is held within the Acquiror group by an intermediate U.K. holding company that is funded by acquisition or shareholder debt, the interest costs of such debt can in principle be offset against the profits of the Target. However, where the interest costs incurred by the holding company in any accounting period exceed the profits of the Target for the period, the excess cannot be offset against future profits of the Target since losses of one group company for a period may only be surrendered against profits of other group companies arising in the same period.

In addition, the extent to which any U.K. intermediate holding company's interest costs are deductible for U.K. tax purposes may be circumscribed by the U.K. tax rules on thinly capitalized companies, the broad effect of which are to limit the deductibility for tax purposes of interest costs on connected party debt (which for this purpose may include third party debt which is guaranteed by connected parties) that exceeds the amount that would be lent to the borrower by a third party lender without the benefit of any such guarantee. Currently the rules do not contain any specific financial ratios for determining whether a company is thinly capitalized, and H.M. Revenue & Customs have in the past several years become increasingly sophisticated in their approach to the third party standard against which any particular arrangement is to be measured. It is now common for certainty to be achieved through negotiation of a ruling through the "Advance Thin Capitalisation Agreement" procedure, which will fix the amount of interest deduction available by reference to agreed performance measures of the underlying business of the Target.

There are also a number of other U.K. tax rules that limit the tax deductibility of interest payments that would need to be analyzed on a case-by-case basis. For example, rules have been introduced that in certain situations prevent any tax deduction for interest payments on shareholder loans if the interest is not taxable in the hands of the lender, for example if the U.K. borrower is treated as a branch of a U.S. lender for U.S. tax purposes as a result of a "check-the-box" election having been made in relation to the U.K. borrower for U.S. tax purposes. Most

recently, a new regime will be introduced with effect from January 1, 2010 which will limit the aggregate net finance expense of the U.K. sub-group of a multinational group by reference to the finance expense of the worldwide group (the "worldwide debt cap"). It is unlikely that this regime will have a significant impact on insurance companies in view of an exemption from the rules for qualifying financial services groups, including those which carry on insurance activities.

d. Improving the Effective Tax Rate

One of the issues on which the Buyer will focus in the due diligence process is the extent to which the acquisition presents opportunities to improve the Target group's effective tax rate or, conversely, whether the acquisition is likely to increase the rate. Where the Target group is being sold out of a larger U.K. group or the Target group itself has a U.K. resident holding company it is unlikely that any intra-group reinsurance or retrocession arrangements will have offered any opportunities to reduce the group's effective tax rate, since the U.K. tax rules on controlled foreign companies will generally prevent the profits attributable to such arrangements (computed in accordance with U.K. tax rules) being taxed at rates which are less than 75% of the U.K. rate. Similarly, if the Buyer is a U.K. company, and the Target group is not owned by a U.K. group or has a U.K. holding company, any such intra-group arrangements may cease to be quite as effective as they were under the previous ownership structure.

The corporate structure for the acquisition may therefore contain features to deal with these issues. In particular, the top holding company in the acquisition structure may be a non-U.K. holding company (such as a Bermuda or Luxembourg company), to which non-U.K. subsidiaries of the Target group may be transferred following the acquisition. Once the non-U.K. subsidiaries cease to be held directly or indirectly by a U.K. parent, the U.K. controlled foreign companies rules cease to apply. The U.K. tax and other consequences of any such transfer will need to be considered carefully. For example, if, as one

would expect, the non-U.K. subsidiary has appreciated in value, reliance may need to be placed on the "SSE" to prevent any charge to U.K. corporation tax arising on the transfer. Although the need for advance consent of the UK tax authorities for such reorganizations was abolished in 2009, transactions involving subsidiaries worth more than £100,000,000 still need to be reported to the U.K. authorities in certain circumstances.

The government is currently undertaking a programme of reform to the U.K. corporation tax system, which has as one of its stated aims making the U.K. tax regime one of the most competitive within the G20. This has led to a reduction in the rate of U.K. corporation tax to the current rate of 24%, and which is due to reduce further to 23% in 2013. There are also fundamental reforms being introduced with effect from January 1, 2013 to the controlled foreign companies rules mentioned above. Whilst much of the legislation implementing such reforms has already been enacted, there remain gaps in the proposed legislative framework, including specific rules relating to insurance business. Accordingly, it is still difficult to predict with certainty how the new rules will influence the structuring issues referred to above. However, offshore reinsurance and retrocession arrangements relating to insurance risks written by a U.K. connected party of the reinsurer or retrocessionaire are likely to be within the scope of the new rules, and to that extent, at least, non-U.K. holding company structures will remain important.

2. U.S. TAX STRUCTURING CONSIDERATIONS

The goals described above also apply to the acquisition of U.S. Targets — minimizing the tax costs of the acquisition itself, avoiding immediate tax for Target shareholders receiving shares as consideration, allowing interest on acquisition debt to be deducted against Target profits and considering the effect of the acquisition on the Target's effective tax rate. The U.S. does not impose a stamp duty comparable to the U.K. stamp duty described above. However, the U.S. does impose a complex

set of federal income tax rules applicable only to insurance companies. The remainder of this Chapter will focus on the application of those rules in the acquisition context.

a. Tax Character of the Target — Life v. Non-Life

Under the U.S. Internal Revenue Code, insurance companies are taxed under one of two basic tax regimes — one that is applicable to "life insurance" companies[2] and one that is applicable to insurance companies other than life insurance companies.[3] The fact that a company may be designated as a life insurance company or as a property and casualty insurance company for state regulatory purposes is not determinative of its tax treatment. In an acquisition context, the treatment of a Target company as a life insurance company or a "non-life" company is significant largely because of the special "life/non-life" consolidated return rules, described below.

(1) Life Insurance Company Defined

A company is treated as an "insurance company" for U.S. tax purposes if more than half of its business is issuing insurance or annuity contracts or reinsuring risks underwritten by insurance companies.[4] An insurance company will be taxed as a life insurance company if (i) it is engaged in the business of issuing or reinsuring life insurance or annuity contracts or noncancellable health and accident insurance policies and (ii) its life insurance reserves plus its unearned premiums and unpaid losses on

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[2] I.R.C. § 801 *et seq.*

[3] I.R.C. § 831 *et seq.*

[4] I.R.C. § 816; Treas. Reg. § 1.801-3.

noncancellable life, accident or health policies not included in life insurance reserves comprise more than 50% of its total reserves.[5]

b. Importance of the Distinction — Life/Non-Life Consolidation

Generally, a group of commonly-held U.S. corporations with a common U.S. corporate parent can elect to file a consolidated federal income tax return. This has several advantages: for example, losses generated by one member of the group can be deducted against the income of another member; transactions between group members generally do not produce current taxable income; and, dividends paid by one member to another are not taxed.

Special rules apply to the filing of consolidated returns by affiliated groups that include life insurance companies.

- Generally, a life insurance company is not eligible to be included in a consolidated return with "non-life companies" (which include both property and casualty insurance companies and corporations that are not insurance companies at all).[6]
- However, if a life insurance company has been "affiliated" (which generally means at least 80% common ownership of aggregate vote and value of common and participating preferred stock) with a group that includes non-life companies for at least five years, the life company becomes eligible for inclusion in the consolidated group if the group makes a "life/non-life election."[7]

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5 Treas. Reg. § 1.801-3(b).

6 I.R.C. § 1504(b)(2).

7 I.R.C. § 1504(c)(2).

- If a non-life company joins a group that includes life insurance companies, the non-life company can be included in the consolidated federal income tax return immediately, but its losses cannot be deducted against the income of life insurance company members until the non-life company has been a member for at least five years.[8]

- Even after a non-life company and a life insurance company have been affiliated for more than five years, operating losses generated by the non-life company can only be deducted against income generated by the life company in any one year to the extent of 35% of the non-life loss or 35% of the life company income (each determined on a "sub-group" basis), whichever is less.[9] For this purpose, income and losses generated by non-life members of a life/non-life group are aggregated on a subgroup basis and any aggregate net loss is then applied, subject to the 35% haircut, against the income of the life subgroup.[10]

These limitations can have important implications for evaluating and structuring the acquisition of life insurance company targets.

(1) Inability to Offset Income and Deductions

Interest on Acquisition Indebtedness. If the Acquiror of a life insurance company target is not itself a life insurance company (including, for example, if it is a holding company that is not an insurance company) and will borrow for purposes of the acquisition, tax deductions generated by the non-life borrower during the first five years will not be deductible against the income of the life company target,

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8 I.R.C. § 1503(c)[b](2).

9 I.R.C. § 1503 (c)[b](1) (this is sometimes referred to as the "35% haircut").

10 Treas. Reg. § 1.1502-47(m).

and, even after five years, will be subject to the 35% haircut described above.

In evaluating the economics of the borrowing it is therefore necessary to determine whether there will be income generated by the Acquiror itself or by non-life companies included in its consolidated return that will be adequate to absorb the interest deductions on a current basis. This can be accomplished easily if the Target's group or the Acquiror's group includes non-life companies that generate sufficient taxable income to absorb the non-life losses. However, even in this situation it may be necessary to undertake some corporate restructuring so that all of the non-life companies qualify for inclusion in the same consolidated return.[11] Netting can also be accomplished if operations generating positive taxable income can be moved out of the life company and into a non-life company. Note, however, that any intercompany transaction intended to generate positive taxable income in non-life companies (for example, by having the life company pay fees for services or lease property from affiliated non-life companies) will be subject to the arm's-length pricing standards of I.R.C. § 482.

Through back-to-back intercompany lending, it may also be possible to "push" the interest deduction into the life company by structuring the acquisition so that the life insurance target itself is ultimately the net borrower. However, such structures may have significant economic or regulatory consequences that must be considered. In some circumstances, it may also be possible to qualify a holding company borrower as a life insurance company that is immediately eligible for consolidation with the Target.

Stock v. Asset Acquisitions. Often, in taxable transactions, a corporate acquiror may prefer to purchase assets rather than stock, or to make an "I.R.C. § 338(h)(10) Election" (discussed below) to treat a stock purchase as an asset purchase for U.S. federal tax purposes. These

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[11] *See* Treas. Reg. § 1.1502-47(e)(1).

transactions can benefit the buyer because the buyer can achieve a "step-up" in the tax basis of purchased assets (both tangible and intangible) if the purchase price (plus assumed liabilities) exceeds the Target's adjusted tax basis in its assets. The stepped up basis can be depreciated or amortized over time (generally, up to 15 years for assets other than real estate). Transactions treated as asset purchases are generally more expensive because the seller is likely to have somewhat higher tax costs from an asset sale than from a stock sale (for which it may seek compensation) and because other transaction costs may be greater.

In evaluating the economic benefits of an actual or deemed asset acquisition of a life insurance company target, it is important to consider whether the extra tax deductions generated by the Target can be used on a current basis. For example, if the deductions are large enough that they will not only shelter all of the life company's taxable income but also produce net operating losses in the life company, it must be determined whether the excess can be used on a current basis by affiliates. If, as a result of the life/non-life rules, the losses cannot be used by affiliates on a current basis and must be carried forward, they are clearly less valuable to the Acquiror than losses that can be used on a current basis. Similarly, if the excess deductions will be generated by non-life members of the Target's group (if, for example, a substantial portion of the purchase price is allocable to non-life subsidiaries of a life insurance company target), will the acquiring group have enough non-life income to absorb the losses or will the losses either be disallowed against life income (during the first 5 years after the acquisition) or be subject to the 35% haircut described above?

(2) Use of Net Operating Losses of Newly-Acquired Non-Life Companies

The Courts have accepted the IRS's "separate company" approach for netting non-life losses generated by newly-acquired subsidiaries against life company income in a consolidated return.[12] This approach has the effect of further restricting the utility of losses generated by newly-acquired non-life members of a life/non-life group.

This issue will arise if a life/non-life group acquires an affiliated group that includes several non-life companies, and some of the newly-acquired non-life companies are profitable while others generate losses during the first five years after the acquisition. At least some companies had taken the position that, for purposes of measuring the amount of losses that would be subject to the five-year prohibition on the use of non-life losses to offset life company income, the acquired non-life companies should be treated as a single entity. Under that approach, losses generated by newly-acquired non-life companies with overall losses would be netted against the taxable income of newly-acquired non-life companies that were profitable, and only the net amount would be subject to the five-year limit on deductibility against life company income. Because all non-life losses must be applied against any available non-life income before they can be used to offset life company income, this approach had the effect of freeing losses generated by old non-life subsidiaries — that were eligible five-year members of the group — to offset the group's life insurance taxable income.

The Tax Court and the U.S. Court of Appeals for the Third Circuit have rejected this approach and treated each newly-acquired company as a separate entity. This will force the acquiring group to deduct non-life

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[12] Connecticut General Life Insurance Co. v. Comm'r, 109 T.C. 100 (1997), *aff'd*, 99-1 U.S.T.C. 50,500 (3d Cir. 1999), *cert. denied,* 120 S. Ct. 496; *See also* IRS Coordinated Issues Paper, "Loss Utilization in a Life-Nonlife Consolidated Return: Separate v. Single Entry Approach" (August 9, 2000).

losses of eligible group members (that could otherwise have been used, subject to the 35% haircut, as deductions against life company income) against the taxable income of newly-acquired non-life members. As a result some losses generated by new group members may be left totally unutilized under the five-year rule.

(3) 100% Dividends-Received Deduction

As noted above, dividends received by one member of an affiliated group filing a consolidated return from another member are not included in the recipient's taxable income.[13] Under the consolidated return rules, the recipient's tax basis in the stock of the payor is adjusted downward by the amount of the dividend.[14]

If a newly-acquired life insurance company that is not eligible to join a consolidated group (because it has not met the five-year affiliation requirement) pays a dividend to its non-life parent, the 100% dividends-received deduction will only apply to dividends paid out of amounts earned by the life company after the acquisition.[15] Any dividend paid out of the life company's pre-acquisition earnings will qualify for an 80% (rather than a 100%) dividends-received deduction, and will therefore be taxed at an effective federal rate of approximately 7% (assuming a 35% corporate tax rate). In addition, distributions out of pre-acquisition earnings and profits will not result in a downward basis adjustment.

In many acquisitions of life insurance companies that have been subsidiary members of affiliated groups filing consolidated returns, pre-acquisition earnings may be reduced to zero immediately prior to

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13 Treas. Reg. § 1.1502-13(f)(2).

14 Treas. Reg. § 1.1502-32.

15 I.R.C. § 243(b).

the acquisition.[16] In that case, post-acquisition distributions in excess of post-acquisition earnings will be treated as tax-free return of basis (or as taxable gain to the extent that the distributed amounts exceed basis). However, the elimination of pre-acquisition earnings will only occur to the extent that the life company's earnings have resulted in adjustments to the earnings of other target group members under the consolidated return regulations.[17] As a result, pre-acquisition earnings may not be reduced to zero in all circumstances. It may be useful to determine, as part of the due diligence process, whether a life insurance company target (or a life insurance company member of a target group) will retain any of its pre-acquisition earnings following a proposed transaction.

This presents a planning opportunity for the acquisition of affiliated groups that include one or more life insurance companies that will have pre-acquisition earnings and profits remaining following the acquisition. Assume a simple case in which the Acquiror will buy the stock of a non-life holding company with a life insurance subsidiary. Dividends paid (whether in the form of cash or notes) by the life insurance company to its non-life parent immediately prior to the closing can qualify for the 100% dividends-received deduction in the Target group's final consolidated return. If any pre-acquisition earnings would otherwise remain in the life insurance company member, it will be in the Acquiror's interest to request in the contract that the Target seek regulatory approval for the largest possible intra-group dividend — up to the amount of the accumulated earnings that would otherwise remain following the closing — in cash or as a note immediately prior to the closing. Following the closing the cash can be distributed from the purchased holding company (which will immediately be includible in the Acquiror's consolidated return) to the Acquiror free of tax. If the distribution is in the form of a note, the note can be repaid any time after the closing without tax consequences. If the same amount were

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16 Treas. Reg. §§ 1.1502-33(e)(1), (e)(2)(ii).

17 *Id.*

distributed by the life company out of its pre-acquisition earnings during the five years following the closing, it would be subject to the 7% effective rate of federal income tax described above.

c. Stock Acquisitions Treated as Asset Acquisitions

As noted above, corporate acquirors in taxable acquisitions will often consider the costs and potential benefits of making an election to treat a stock purchase as an asset purchase for federal income tax purposes — the so-called "Section 338(h)(10) Election."

The Treasury Regulations provide comprehensive rules for the taxation of insurance company acquisitions that are deemed to be taxable as asset sales as a result of a Section 338(h)(10) Election.[18] Key elements of these regulations also apply to insurance company acquisitions that are structured as true assets sales.

(1) General Requirements for Section 338(h)(10) Election

In order for a Section 338(h)(10) Election to be made:

- The Acquiror must be a corporation.[19]
- The seller must be either (i) one or more corporations that are members of a consolidated federal income group that includes the Target or (ii) a single corporation that owns at least 80% of the stock of the Target but is not included in the same consolidated return with the Target.[20]

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18 Treasury Decision 9257, 2006-1 C.B. 821 (April 7, 2006); *see Treas. Reg.* § 1.338-1(a)(2).

19 I.R.C. § 338(a).

20 Treas. Reg. § 1.338(h)(10)-1(c).

- The Acquiror must purchase at least 80% of the stock of the Target (during a 12-month period) in one or more entirely taxable transactions.[21]
- The Acquiror and the seller must file a joint election with the IRS to apply Section 338(h)(10), no later than the 15th day of the ninth month following the closing.[22]

(2) Consequences of a Section 338(h)(10) Election

To understand the principal federal income tax consequences of Section 338(h)(10) transactions involving insurance companies, it is useful to contrast the rules generally applicable to Section 338(h)(10) transactions with the rules generally applicable to the sale by an insurance company of a block of business on its books in an assumption reinsurance transaction.

Purchase of Assets under Section 338(h)(10). If a Section 338(h)(10) Election is made:

- The seller is not taxed on its sale of the Target stock.[23]
- The Target is subject to tax as if it (i) sold its assets to "new Target" on the closing date for a price that is generally equal to the sum of (x) the price paid by the Acquiror for the stock and (y) the amount of the Target's liabilities as of the closing date, and (ii) then liquidated and distributed the purchase price to its shareholders.[24]

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21 I.R.C. § 338(d)(3).

22 Treas. Reg. § 1.338(h)(10)-1(c)(2).

23 I.R.C. § 338(h)(10).

24 Treas. Reg. § 1.338(h)(10)-1(d)(4).

- If the Target was a member of an affiliated group filing a consolidated return prior to the acquisition, the gain or loss on the deemed sale of assets is included in the consolidated return of the selling group.[25] See the discussion below for special rules that apply when the Target is not included in a consolidated return prior to the transaction.
- The "new Target" is deemed to have purchased the assets and takes a federal income tax basis in the assets generally equal to the sum of (i) the price paid by the Acquiror for the stock; (ii) the amount of the Target's liabilities as of the closing date; and (iii) certain other items, including the Acquiror's acquisition expenses.[26]
- The tax basis is allocated among the assets based on their relative fair market values under a "residual method", based on asset categories specified in the regulations.[27] Subject to the application of the "DAC" rules discussed below, any amount allocable to goodwill and certain other intangibles, including "insurance-in-force," is amortizable over 15 years.[28]

Assumption Reinsurance. Under the rules of Subchapter L, when an insurance company acquires a book of insurance business in force, the tax consequences are determined somewhat differently than they are in a purchase of assets: as if the seller (or "ceding company") paid the acquiring company to take on the liabilities inherent in the acquired book of business (a "reinsurance premium"), in an amount equal to the insurance liabilities transferred, and the acquiring company paid an offsetting amount (a "ceding commission"), which, in an arm's-length transaction, would be equal to the fair market value to the acquiring

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25 Treas. Reg. § 1.338(h)(10)-1(d)(3).

26 Treas. Reg. §§ 1.338(h)(10)-1(d)(2), 1.338-5.

27 Treas. Reg. §§ 1.338(h)(10)-1(d)(2), 1.338-6 and -7.

28 I.R.C. § 197.

reinsurer of the book of business going forward. Generally, the tax consequences are as follows:[29]

- The ceding company recognizes ordinary income, equal to the reduction in its reserves attributable to the transfer of the assumed liabilities;
- The ceding company has an ordinary deduction equal to the reinsurance premium paid;
- The ceding company has ordinary income equal to the ceding commission it receives or is deemed to have received;
- The acquiring company recognizes ordinary income equal to the reinsurance premium received;
- The acquiring company has an ordinary deduction equal to the increase in its reserves attributable to the assumed liabilities; and
- Depending upon the nature of the reinsurance and type of business ceded, the acquiring company may, subject to the "DAC" rules described below, either deduct currently or be required to amortize the ceding commission over the life of the assumed contracts.

The DAC Rules. Treatment of a transaction as an assumption reinsurance transaction with a reinsurance premium payment, as opposed to a more conventional asset sale, will also have consequences for old Target and new Target under the "DAC" (or "deferred acquisition cost") rules. An insurance company is generally required to

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[29] Treas. Reg. Section 1.817-4(d); Colonial American Life Ins. Co. v. Comm'r, 491 U.S. 244, 89-1 U.S.T.C. 9377 (1989). Although the Treasury Regulation, by its terms, applies only to life insurance companies, the IRS has taken the position that the principles of Section 1.817-4(d) are equally applicable to property and casualty companies. *See, e.g.*, Rev. Rul. 76-411, 1976-2 C.B. 208; F.S.A. 1998-476 (August 31, 1998), *citing* Union Bankers Ins. Co. v. Comm'r, 64 T.C. 807 (1975), *acq.* 1976-2 C.B. 3.

capitalize a portion of its otherwise deductible expenses equal to a percentage of premiums received with respect to specified insurance contracts.[30] The capitalized amount is amortized over a 10-year period. The DAC rules generally apply to reinsurance of "DACable" contracts (specified in I.R.C. § 848(e)), by allowing the ceding company to reduce its unamortized DAC balance (generally, the unamortized portion of capitalized expenses attributable to the ceded contracts) and requiring the assuming company to increase its DAC balance by a portion of the reinsurance premium received.[31] If the contracts transferred in a reinsurance transaction are subject to the DAC rules, the ceding commission attributable to the DACable contracts is not required to be amortized as described in Treas. Reg. § 1.817-4(d) and *Colonial American Life* and may be deducted currently.[32] However, if the overall transaction is one to which Section 197 applies (including an assumption reinsurance transaction that is deemed to occur as a result of a Section 338(h)(10) Election), any excess of the ceding commission paid or deemed paid over the DAC amount must be amortized over 15 years.[33] (As a result, assumption reinsurance treatment can result in a benefit to the buyer, since a portion of the purchase price that might otherwise be attributable to 15 year "goodwill" will instead be amortized over ten years under the DAC rules.)

(3) Issues in Insurance Company Section 338(h)(10) Transactions

For many years, prior to the release of the current regulations in 2006, it was not clear whether "purchase of assets" or "assumption reinsurance" principles should apply to insurance company acquisitions

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30 I.R.C. § 848.

31 Treas. Reg. § 1.848-2.

32 I.R.C. § 848(g).

33 I.R.C. § 197(f)(5); *see* H.R. Rep. No. 103-11, 103d Cong. 1st Sess. at n.150.

under Section 338(h)(10) to determine the tax treatment of the deemed sale of the insurance-in-force on the Target's books, and, under either paradigm, how the relevant amounts allocable to the insurance contracts deemed to be transferred should be calculated.

More specifically, the uncertainties related to the following questions:

- When a book of insurance business is deemed transferred as a result of a Section 338(h)(10) Election, do the general "purchase of assets" rules for Section 338(h)(10) transactions, described above, apply or should the tax consequences of the deemed transfer of insurance policies be determined under the rules applicable to "assumption reinsurance" under Subchapter L?
- To determine the consequences of the Section 338(h)(10) Election, should the insurance reserves held by the Target immediately before the acquisition be treated as "liabilities" assumed by the new Target, and if so, should the amount of the insurance liabilities assumed by the new Target be calculated on the basis of the Target's statutory reserves (as reflected on its annual statement filed with insurance regulators) or on the basis of its insurance reserves as computed for tax purposes (which, because of discounting and interest rate assumptions required under the Code,[34] are often substantially lower, particularly for property/casualty companies)?
- If the deemed transaction is treated as involving assumption reinsurance, how should the purchase price paid for the contracts, including the ceding commission for the insurance-in-force, be calculated?
- What is the result in a so-called "negative ceding commission" case: if the fair market value of the assets deemed transferred to the new Target exceeds the amount of the insurance

[34] IRC §§ 807, 846, 832(b)(4).

liabilities that new Target is deemed to have assumed, should the acquiror ("new" Target) reduce its basis in the acquired assets (under the "purchase of assets" model) or recognize immediate income (as if it had received a reinsurance premium in an amount greater than the increase in its reserves)?

Under the Treasury Regulations, "if Target is an insurance company for which a section 338 election is made, the deemed asset sale would be characterized and taxed as an assumption-reinsurance transaction under applicable federal income tax law. See § 1.817-4(d)."[35] This characterization also applies to Section 338(h)(10) transactions.[36] The regulations include detailed rules regarding the application of the principles generally applicable to assumption reinsurance transactions to the transfer of insurance and annuity contracts deemed to have occurred as a result of an election under Section 338 (including an election under Section 338(h)(10)). These regulations also apply for purposes of allocating the purchase price in the acquisition of an insurance business structured as an actual asset sale (an "applicable asset acquisition") but do not apply to "mere" reinsurance arrangements that are not part of the acquisition of a business (see discussion below).[37] In particular, the regulations include a number of special rules to address the questions described above:

- In a Section 338(h)(10) transaction or applicable asset acquisition, the Target's insurance reserves as computed for federal income tax purposes (not its statutory reserves) immediately prior to the acquisition are treated as fixed liabilities assumed by the "new Target," so the purchase price

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[35] Treas. Reg. § 1.338-1(a)(2)*; see*, *e.g.*, Priv. Ltr. Rul. 9331002 (Apr. 23, 1993); Priv. Ltr. Rul. 9427001, (Mar. 24, 1994); F.S.A. 1998-476 (August 31, 1998); F.S.A. 1999-1015 (April 2, 1993); F.S.A. 200018004 (December 22, 1999).

[36] Treas. Reg. § 1.338(h)(10)-1(d)(4).

[37] Treas. Reg. §§ 1.338-11; 1.1060-1(b)(9), -(c)(5).

deemed paid for the Target's assets will include the full amount of the tax reserves.[38]

- The amount of the purchase price that is deemed to be paid for the insurance-in-force is determined under the "residual method" of the Section 338 and Section 1060 regulations, treating as the "fair market value" of the insurance contracts the amount that a willing reinsurer would pay a willing ceding company to acquire the Target's insurance-in-force if the gross reinsurance premium were equal to the Target's tax reserves.[39]

- For purposes of calculating the results of the assumption reinsurance transaction that is deemed to occur in a Section 338(h)(10) transaction, the amount deemed paid to "new Target" as a reinsurance premium in consideration for the assumption of the Target's insurance reserves is always deemed to equal the amount of the Target's insurance reserves as computed for federal income tax purposes. This generally eliminates the possibility that the "new Target" will be forced to recognize ordinary income as a result of the transaction in a "negative ceding commission" case,[40] and will instead result in a reduced basis in the acquired tangible assets — which is the same result that would occur in a "bargain" purchase not involving insurance companies.[41] Similar rules apply in the case of an applicable asset acquisition.[42]

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38 Treas. Reg. § 1.338-11(b)(1).

39 Treas. Reg. § 1.338-11(b)(2).

40 Treas. Reg. § 1.338-11(c)(2).

41 *See* Comm'r. v. Oxford Paper Co., 194 F.2d 190, 52-2 U.S.T.C. 9284 (2d Cir. 1952); Rev. Rul. 55-675, 1955-2 C.B. 567.

42 Treas. Reg. § 1.1060-1(c)(5).

(4) Other Special Rules in the Regulations

The regulations impose a number of additional special rules on insurance company acquisitions that are either structured or treated as asset sales for federal income tax purposes, including the following:

- In some instances, increases in the Target's insurance reserves during the first four taxable years after an acquisition for which a Section 338(h)(10) Election is made (or an applicable asset acquisition) are not deductible, as they are under normal federal income tax rules.[43] Instead, "new Target" (or the purchaser in an applicable asset acquisition) must recognize additional premium income, equal to the amount of the increase in reserves, and must capitalize the reserve increase as part of the cost of the acquired assets.[44] Capitalization is required only for increases in reserves that reflect a so-called "bargain purchase" – that is, when the fair market value of the Target's tangible assets (including cash, stocks and securities, accounts receivable and other tangible real and personal property) as of the acquisition date exceeded the sum of (i) the cash paid by the acquiror in the transaction plus (ii) the insurance reserves (as computed for tax purposes) of the Target as initially reported plus the other liabilities of the Target at the time of the acquisition.[45] As described in the Treasury Department explanation of the regulations, that excess is the amount that would have been reportable by the acquiror as ordinary income if the regulations had adopted a "pure" assumption reinsurance approach to calculating the consequences of a Section 338(h)(10) transaction or applicable asset acquisition – rather than assuming, as described above, that the reinsurance

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[43] I.R.C. §§ 805(a)(2), 832(b)(5).

[44] Treas. Reg. §§ 1.338-11(d)(1), 1.1060-1(c)(5).

[45] *See* Treas. Reg. § 1.338-11(d)(4).

premium received by the acquiror is equal to the tax reserves for the acquired business.[46] Given that deviation from a "pure" assumption reinsurance model, the proponents of the approach taken by the regulations believe that it is appropriate to require capitalization of reserve increases for the acquired business – rather than permit the ordinary deduction that would be applicable to reserve increases following a true reinsurance transaction. Moreover, the Treasury Department explanation takes the position that, without requiring capitalization of at least some increases in reserves, there would be an incentive for buyers and sellers to agree to defer increases in reserves until after the acquisition – as the seller would derive no tax benefit (or detriment) from reserve increases immediately preceding a sale, while the buyer might obtain an immediate deduction.[47] The capitalization requirement does not apply to reserve increases attributable to increases in the present value of future liabilities as a result of the mere passage of time,[48] to adjustments in life insurance reserves resulting from a change in the basis of computing reserves that are subject to the "ten-year spread" under section 807(f), or to adjustments made by a company under state receivership.[49] As a result of the carve-outs, the capitalization requirement is far more likely to apply to increases in property and casualty reserves than to increases in life insurance reserves.

- For purposes of the capitalization rules of Section 197 of the Code, the amount paid or incurred to acquire insurance contracts in a transaction governed by Section 338 or an

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[46] Treas. Decision 9257, *supra*; *see* Treas. Decision 9377, I.R.B. 2008-11, 578 (January 23, 2008).

[47] Treas. Decision 9257, *supra*.

[48] Treas. Reg. §§ 1.338-11(d)(3)(i), (ii).

[49] Treas. Reg. § 1.338-11(d)(2).

applicable asset acquisition is the amount of the deemed purchase price allocated to the contracts as a ceding commission under the Section 338 or 1060 regulations.[50]

- The regulations include additional rules regarding the triggering of "policyholders surplus accounts" of life insurance companies with respect to which an election under Section 338(h)(10) is made; the interplay of Sections 197 and 848; the disposition of acquired insurance contracts governed by Section 197(f); the carryover of remaining DAC balances of the Target following a Section 338(h)(10) Election; the use by "new Target" of "old Target's" historical loss experience in calculating its discounted reserves under Section 846(e); and other technical issues that are beyond the scope of this Chapter.[51]

- As described above, the assumptions and rules described in the Section 338 regulations will determine the treatment of reinsurance transactions that occur as part of "applicable asset acquisitions" (governed by Section 1060 and the new regulations) but will not apply to assumption or indemnity reinsurance arrangements that are not part of broader acquisitions. For example, the requirement that some subsequent reserve increases be capitalized will only apply after an "applicable asset acquisition". There is very little guidance,

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[50] Treas. Reg. § 1.197-2(g)(5)(ii)(B).

[51] For a more complete discussion of the current regulations as they had originally been proposed in 2002, including a more detailed explanation of the interaction of Section 338 and the assumption reinsurance rules, *see* Salem, Irving and Rosen, Seth L., "*Proposed Regulations Provide Creative and Helpful Guidance for Insurance Acquisitions But Would Impose Major New Capitalization Requirements*," 16 Journal of Taxation of Financial Institutions 5 (Sept./Oct. 2002), reprinted at 23 Insurance Tax Review 651 (Nov. 2002); *see also* Kovey, Mark H. and Jones, Lori J., "*The Final Section 338 and 1060 Regs: Blending Corporate and Insurance Tax Principles*," 30 Insurance Tax Review No. 6 979 (June 2006).

however, on the question of when a reinsurance transaction (for example, the acquisition of a line of business by assumption reinsurance or 100% coinsurance) will be treated as an applicable asset acquisition and when it will not. Generally applicable regulations state that a transaction will be treated as an applicable asset acquisition "if the assets transferred constitute a trade or business in the hands of either the seller or the purchaser," and that this will generally be true if the character of the acquired assets is "such that goodwill or going concern value would under any circumstances adhere" to the acquired assets.[52] However, the regulations also provide that the "mere" reinsurance of insurance contracts by an insurance company is not an applicable asset acquisition "even if it enables the reinsurer to establish a customer relationship with the owners of the reinsured contracts." A reinsurance arrangement will constitute an applicable asset acquisition "if the purchaser acquires significant business assets, in addition to insurance contracts, to which goodwill and going concern value could attach."[53] In some cases – when an acquisition includes a sales force, proprietary computer programs and other significant and valuable intangible assets – the distinction will be obvious, but in many practical circumstances it may be less clear whether traditional principles, or the regulations governing applicable asset acquisitions, should apply.

d. Special Rules — Section 338(h)(10) Elections for Non-Consolidated Subsidiaries

A Section 338(h)(10) Election can be made with respect to the disposition of an 80%-owned subsidiary that is not included in the

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52 Treas. Reg. § 1.1060-1(b).

53 Treas. Reg. § 1.1060-1(b)(9).

seller's consolidated return, including a life insurance subsidiary that is not includible in the seller's consolidated return because it has not been owned for the five-year period required by I.R.C. § 1504(c)(2).[54]

In addition, on the sale of the stock of a consolidated subsidiary (*e.g.*, a lower-tier holding company) that, at the time of sale, owns the stock of an ineligible life subsidiary, a Section 338(h)(10) Election can be made for both the consolidated holding company subsidiary and its ineligible life subsidiary.[55]

If a Section 338(h)(10) Election is made for a subsidiary that is not included in the Seller's consolidated return, the transaction is taxed as if the Target had sold all of its assets on the closing date and then liquidated on a tax-free basis under I.R.C. § 332. The structure raises contractual issues that are not present in the case of a "traditional" Section 338(h)(10) Election with respect to the sale of a Target that was included in the seller's consolidated return:

- The seller's consolidated group losses cannot be used to offset gain on the sale. This may affect the seller's willingness to make the election.
- The Target's own losses and any credit carryforwards will be used to offset § 338(h)(10) gains. This could affect the buyer's economics. Also, if, under the terms of the stock purchase agreement, the seller pays taxes attributable to the Section 338(h)(10) gain but the Target (following the closing) pays its own taxes attributable to "normal" operations in the year of sale, the buyer and seller will need to allocate the available losses and any credits or other carryforwards between the two segments of the final return to determine the amount each will pay.

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54 Treas. Reg. § 1.338(h)(10)-1(d)(3)(ii); *see* Priv. Ltr. Rul. 9543036 (July 31, 1995); Priv. Ltr. Rul. 9623023 (Mar. 6, 1996).

55 *See* Treas. Reg. § 1.338(h)(10)-1(d)(3)(ii).

- All of the gain from the sale is reported on the Target's stand-alone return following the closing (rather than the seller's consolidated return). If the seller is contractually liable for taxes attributable to the sale, while the buyer will own the Target company and will prepare and file the Target's stand-alone final return following closing, the buyer and seller must negotiate a process for preparing and filing the return, paying taxes and handling audits.

3. THE DUE DILIGENCE PROCESS — SPECIAL U.S. CONCERNS

In most acquisitions, the tax due diligence process focuses almost entirely on the Target's own real and potential tax liabilities for open tax years. All the concerns typically addressed as part of that process — pending and potential audit issues, consolidated group liabilities, potential obligations to others under tax sharing and indemnity agreements — are relevant to the process of investigating the tax posture of an insurance company Target. In that regard, knowledge of the special tax regimes that apply to life insurance or property and casualty insurance companies is, of course, essential.

In addition, it is crucial to bear in mind that, particularly in the case of life insurance companies, insurance products themselves are highly tax sensitive. It is essential to focus on the tax status of the products and on the procedures that the Target has in place to assure that the products qualify for the favorable tax treatment that policyholders expect to receive.

a. Life Insurance Product Qualification Issues

Life insurance contracts receive highly favorable tax treatment under the Code. Among other benefits, "inside build-up" — the increase in cash value attributable to investment earnings on or interest credited to premiums paid into variable, universal life or whole life products — is

not taxed to the policyholder as it is earned. In most cases distributions from life insurance policies are treated first as a return of premiums paid and are only taxed once an amount in excess of the premium payments has been withdrawn.[56] Moreover, death benefits under a life insurance policy are tax-free to the beneficiary.[57]

Congress has imposed complex requirements that distinguish tax-favored insurance products from less favorably taxed investment products for U.S. federal income tax purposes. These requirements are generally intended to deny life insurance or annuity treatment to products that are too investment oriented — generally, those that either permit the policyholder to invest a large amount in the policy relative to the amount of insurance coverage provided, or are deemed to give the policyholder too much control over how premiums paid into the contract are invested.[58]

The tax cost of failing to qualify falls, in the first instance, on the customer. If a policyholder owns a contract that fails to qualify as life insurance or as an annuity for tax purposes, the policyholder can become immediately taxable on the inside build-up that has accumulated in the contract — even though no cash has been distributed.[59] Although there are remedial steps that a company which has inadvertently allowed its products to fail to qualify can take to avoid the imposition of tax on the policyholders, these steps can be expensive and complicated.[60] As a result, failure of the Target's products to qualify

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56 I.R.C. § 72(e).

57 I.R.C. § 101.

58 I.R.C. §§ 817(h), 7702.

59 I.R.C. § 7702(g); Treas. Reg. § 1.817-5.

60 *See* I.R.C. § 7702(f)(8); Treas. Reg. § 1.817-5(a)(2); Rev. Proc. 2008-42, I.R.B. 2008-29, 160 (July 1, 2008); Rev. Proc. 2008-40, I.R.B. 2008-29, 151 (June 30, 2008); Rev. Proc. 2008-38, I.R.B. 2008-29, 139 (June 30, 2008); Notice 2007-15, 2007-1 C.B. 503 (Jan. 26, 2007).

under applicable Code provisions can affect not only the company's current balance sheet, but also its future business prospects.

Although a detailed discussion of the qualification rules is beyond the scope of this Chapter, a summary of the elements that should be considered as part of the due diligence process follows.

(1) Section 7702 — Qualification of Products as Life Insurance

In order for a contract to qualify as a life insurance policy for federal income tax purposes, it must (i) be treated as a life insurance contract under "applicable" state or foreign law and (ii) meet either the "cash value accumulation test" or the "guideline premium/cash value corridor test" described in I.R.C. § 7702.[61]

"**Cash Value Accumulation Test**." Under this test, by the terms of the contract the cash surrender value of a life insurance policy can never exceed the "net single premium" that would be payable at a given point in time to fund the future benefits under the contract.[62] A policy is tested when it is issued, and is retested any time the benefits under the contract change.[63] Variable contracts must be tested at least annually.[64]

"**Guideline Premium/Cash Value Corridor Test**." Under this test, the premiums actually paid into a contract can never exceed the greater of the "guideline single premium" (which is, generally, the amount that would be payable at issue to fully fund the future benefits under the contract) or the sum, as of the date of payment, of the "guideline level

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61 *See* General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (H.R. 4170, 98th Cong., P.L. 98-369) at 646.

62 I.R.C. § 7702(b)(1).

63 I.R.C. § 7702(f)(7).

64 I.R.C. § 7702(f)(9).

premiums" (which is the level amount that would be paid annually, over a period ending not before the insured attains age 95, to fund the contract benefits).[65] The guideline premiums must be recomputed if the benefits under an outstanding policy change and, in the case of variable contracts, must be recomputed at least annually.[66] In addition, under the "cash value corridor" portion of the test, the death benefit must, at all times, equal or exceed the product of the cash value multiplied by a percentage amount specified in the Code (ranging from 250% at age 40 to 100% at age 95).[67]

If premiums paid into a policy exceed the guideline premium limits, they will not cause the policy to fail if they are returned to the policyholder, with interest, no later than 60 days after the end of the contract year in which they are paid.[68]

Due Diligence Issues. Policy language must be reviewed to confirm that the Target's policy forms meet the requirements of I.R.C. § 7702. For example, the death benefit/cash value ratios mandated by both tests are frequently maintained by contract language providing that, in all circumstances, the death benefit will be adjusted to meet the minimum level required at all times to meet the selected life insurance testing option.

It is important to ask whether the Target has identified any failed contracts and, if so, whether relief for any failure to comply has been requested from the IRS under I.R.C. § 7702(f)(8). In order for such relief to be obtained, the company generally must pay to the IRS an amount equal to the tax the policyholders would have paid — current tax on the inside build-up — if the failure had not been corrected

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65 I.R.C. § 7702(c).

66 I.R.C. §§ 7702(f)(7), (f)(9).

67 I.R.C. § 7702(d).

68 I.R.C. § 7702(f)(1)(B).

voluntarily.[69] Relief may be denied if a company has repeatedly applied to the IRS for the correction of allegedly "inadvertent" failures or if the IRS determines that the company did not have appropriate procedures in place that were reasonably expected to avoid contract failures.

Actuarial due diligence is necessary to review the procedures that the Target has in place to assure compliance — so that premium limits are accurately computed when contracts are issued and recomputed as necessary during the terms of the policies (for example, when the death benefit changes) and premium payments are monitored so that any premiums paid in excess of a policy's limit under the selected life insurance testing option are returned to the policyholder as required under the Code. If the Target's systems and procedures that are in place as of the closing date to monitor compliance will continue to be used after the closing, consideration should be given to appropriate indemnification provisions to protect the Acquiror in the event that compliance problems emerge following the closing. In some instances, these protections will expire once the Acquiror has had a reasonable period of time to test the system.

If an insurance company has failed contracts outstanding, and relief under I.R.C. § 7702(f)(8) has not been requested, the Target may also be subject to penalties for failure to file information reporting returns with respect to the distributions that are deemed to have been made from the failed contracts.[70]

(2) Section 7702A — Modified Endowment Contracts

A policy that meets the I.R.C. § 7702 definition of life insurance will be treated as a "modified endowment contract" if the premiums paid into

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69 Rev. Proc. 2008-42, *supra*; Rev. Proc. 2008-40, *supra*; Rev. Proc. 2008-38, *supra*; Notice 2007-15, *supra*.

70 Rev. Rul. 91-17, 1991-1 C.B. 190.

the contract during its first seven years (or during the seven years following certain changes in terms) exceed the limits described in I.R.C. § 7702A. A "modified endowment contract" still enjoys the principal tax advantages of life insurance — no current tax on inside build-up and tax-free death benefits — but withdrawals from a "MEC" are first treated as taxable distributions of income (rather than return of premium),[71] and policy loans (as well as loans secured by a pledge of the MEC) are treated as taxable distributions rather than tax-free loans.[72] In addition, amounts distributed (or treated as distributed) from a MEC before the recipient attains age 59½ can be subject to a 10% penalty tax.[73] Excess premiums paid into a policy will not cause it to become a MEC if the premiums are returned (with interest) no later than 60 days after the end of the policy year in which they are paid.[74] Companies are allowed to correct "inadvertent non-egregious failures" to comply with the MEC rules by paying an excise tax based on the investment earnings on the "excess" premiums paid into the contract.[75]

Due Diligence Issues. Clearly, a policyholder whose policy has inadvertently been allowed to become a MEC can have unexpected negative tax consequences. As a result, many life insurance companies have mechanisms in place to set seven-year premium limits, monitor premium payments and give policyholders the option of receiving premium refunds if a premium that has been paid would cause a contract to become a MEC. The existence and adequacy of these procedures should be reviewed as part of the due diligence process.

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71 I.R.C. § 72(e)(10).

72 I.R.C. § 72(e)(4).

73 I.R.C. § 72(v).

74 I.R.C. § 7702A(e)(1)(B).

75 Rev. Proc. 2008-39, I.R.B. 2008-29, 143 (June 30, 2008); Notice 2007-15, *supra*; *see also* Rev. Proc. 2001-42, 2001-2 C.B. 212 (Aug. 6, 2001); Rev. Proc. 2007-19, 2007-1C.B. 515 (January 26, 2007); Rev. Proc. 99-27, 1991-1 C.B. 1186 (May 18, 1999).

Policyholder sales materials should be reviewed to determine whether the company has promised prospective policyholders that contract payments would be monitored for MEC treatment and, if so, whether the standard promised has been met.

In addition, it should be determined whether the company has requested, or intends to request, relief under Rev. Proc. 2008-39 (or its predecessors, Rev. Proc. 2007-19, Rev. Proc. 2001-42 or Rev. Proc. 99-27) with respect to any inadvertent MECs. Proper reserves should be established for any costs associated with correcting any inadvertent MECs that have been identified. In addition, procedures should be in place to inform MEC policyholders of the negative tax consequences that may result from loans, cash withdrawals, and other transactions involving any MECs that may not be corrected.

(3) Section 817 — Qualification of Separate Accounts and Variable Products

Variable life insurance, annuity and pension products that provide for the allocation of premium payments to segregated asset accounts are subject to additional rules under I.R.C. § 817 and a series of IRS rulings.[76] Most significantly, a variable life insurance policy or annuity contract will not be treated as life insurance or as an annuity under the Code unless the investments held in the segregated asset account are adequately diversified, as prescribed in Treasury regulations under I.R.C. § 817, as of the end of each calendar quarter.[77] If a contract fails the diversification test, the holder will be taxable at ordinary income rates on

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[76] *See* Rev. Rul. 2007-7, 2007-1 C.B. 468 (Jan. 11, 2007); Rev. Rul. 2005-7, 2005-1 C.B. 465 (Jan. 19, 2005); Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 81-225, 1981-2 C.B. 12; Priv. Ltr. Rul. 9433030 (May 25, 1994).

[77] I.R.C. § 817(h); Treas. Reg. § 1.817-5(b). This requirement does not apply to pension plan contracts.

all of the inside build-up, as if the accumulated earnings were distributed in cash as of the first quarter in which the test is failed, and will be currently taxable to the holder as ordinary income in each subsequent quarter.[78]

In addition, the IRS takes the position that a variable contract will not qualify as insurance or as an annuity if the policyholder has an inappropriate degree of control over the manner in which assets held through the contract are invested.[79] Particularly in situations in which the Target sells privately-placed variable products, including COLI (company owned life insurance) programs, there may be circumstances under which investment management arrangements may be deemed aggressive under the IRS approach.

Diversification. A segregated asset account may invest in one or more mutual funds or other pooled investment vehicles. In that event, the insurer will typically rely on "look-through" rules contained in the regulations that permit diversification to be tested based on assets held by the underlying vehicle.[80] Additional requirements for these look-through rules must be met. For example, if the pooled investment vehicle is a corporation or business trust, it must qualify as a regulated investment company under I.R.C. § 851. In addition, in order to qualify for the look-through rule, pooled investment vehicles must be owned exclusively by segregated asset accounts of insurance companies and certain other permitted investors identified in the regulations and IRS rulings.[81]

Regulations adopted in 2005 extended to partnerships that are not registered under a federal or state law governing the sale of securities

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[78] Treas. Reg. § 1.817-5(a).

[79] *See* T.D. 8101, 1986-2 C.B. 97 (Jan. 1, 1986).

[80] Treas. Reg. § 1.817-5(f).

[81] Treas. Reg. §§ 1.817-5(f)(2), (3); T.D. 9385 I.R.B. 2008-15, 735 (March 7, 2008); Rev. Rul. 94-62, 1994-2 C.B. 164.

(for example, privately-placed investment partnerships like hedge funds) the requirement that a pooled investment vehicle must limit its investors to segregated asset accounts of life insurance companies or other permitted investors specified in the regulations in order to qualify for the look-through rule.[82] Under prior regulations, non-registered partnerships qualified for look-through treatment regardless of whether they permitted other investors. The 2005 regulations apply to all investments by segregated asset accounts in non-registered partnerships — even investments made before the regulations were finalized on February 28, 2005.[83]

Investor Control. In a 2003 Revenue Ruling, the IRS concluded that a variable life insurance policy violated the "investor control" requirement described above if the policyholder could designate that premiums be invested in a privately-placed investment partnership (including a hedge fund) accepting direct investment by non-segregated asset account investors.[84] The Revenue Ruling concludes that the holder of a life insurance (or annuity) contract whose premiums are invested in such a partnership would be treated as owning the partnership interests directly, losing the benefits of tax-free inside build-up.[85] The position articulated in Revenue Ruling 2003-92 had been criticized as inconsistent with Treas. Reg. § 1.817-5(f)(2)(B)(ii), as in effect prior to its 2005 amendment by T.D. 9185, as described above. However, the Revenue Ruling applies by its terms to investments made prior to the adoption of the new regulations in 2005.[86] A Revenue Ruling expands

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82 T.D. 9185, 2005-1 C.B. 749 (February 28, 2005).

83 Treas. Reg. § 1.817-5(i)(2)(v); T.D. 9185, *supra.*

84 Rev. Rul. 2003-92, *supra*; *see also* Priv. Ltr. Rul. 200244004 (dated May 2, 2002, which was publicly released on November 4, 2002).

85 Rev. Rul. 81-225, *supra.*

86 *See*, *e.g.*, Letter by Hugh T. McCormick to Hon. Pamela F. Olson, Assistant Secretary for Tax Policy, Office of Tax Policy, U.S. Treasury Department (Feb. 4, 2002) (commenting on Priv. Ltr. Rul. 200244004, *supra*, to the same effect).

the list of permitted investors under the "investor control" doctrine to include other (non separate account) investors who had previously been identified in regulations and IRS rulings as acceptable investors under the diversification rules described above.[87]

A companion ruling to Revenue Ruling 2003-92 describes in detail circumstances in which a policyholder may be deemed to have an inappropriate degree of influence or control over the investment of separate account assets, or the selection of an investment advisor, under the investor control doctrine.[88] The Revenue Ruling limits any communication between policyholders and either insurance companies or investment managers regarding the selection of particular investments or the choice of investment advisors. As in the case of Revenue Ruling 2003-92, policyholders who are deemed to exercise an impermissible degree of influence or control are deemed to own the underlying assets directly. Under the ruling, policyholders are permitted to make choices among broad investment strategy options by allocating their premiums among separate sub-accounts or underlying funds that only permit investment by insurance company separate accounts.

Due Diligence Issues. The due diligence process should include at least a sampling of the quarterly financial statements of any separate accounts maintained by the Target (or of any underlying funds) and should also review any underlying fund's compliance with the requirements for look-through treatment — for example, whether the fund qualified as a regulated investment company and whether investment in the fund is limited to "permitted investors" under the Treasury regulations.

If the underlying fund is managed by a third party investment manager, the investment management or subscription agreement between the manager and the insurance company will often contain indemnification provisions under which the manager will protect the company from its

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[87] Rev. Rul. 2007-7, *supra.*

[88] Rev. Rul. 2003-91, *supra.*

failure to manage the fund in a manner that (i) meets the diversification tests; (ii) avoids "investor control" issues; and (iii) meets the other applicable requirements for look-through treatment. The existence and adequacy of these undertakings should also be reviewed.

In addition, it is advisable (particularly if the Target has issued privately placed variable products or variable COLI contracts) to determine the extent to which the Target's practices conform with the IRS position articulated in Revenue Rulings 2003-91 and 2003-92 and diversification rules described in the regulations.

As with I.R.C. § 7702 and § 7702A compliance, the Acquiror should inquire whether relief has been requested from the IRS for any inadvertent failure to meet the diversification test and the likelihood (and likely cost) of obtaining any such relief should be determined.[89]

b. Qualification of Annuities

Like life insurance contracts, annuity contracts receive special tax treatment. Under a contract that qualifies as an annuity for federal income tax purposes, inside build-up is not taxed to the contract holder until distributions are made.[90] Moreover, amounts paid in the form of annuity payments are prorated between non-taxable return of basis and taxable income, so that basis is recovered ratably over the expected term of the annuity payments.[91] Although there is no clear guidance from the IRS or Treasury, a purported annuity contract that fails to meet the requirements of Section 72 is probably treated as a debt instrument subject to all applicable code provisions (including, possibly, the OID rules). Thus, failure of a contract that was sold as an annuity to qualify under Section 72 can have serious implications for the contract holders.

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89 *See* Rev. Proc. 2008-41, I.R.B., *supra*; Notice 2007-15, *supra*.

90 I.R.C. § 72(e).

91 I.R.C. § 72(b).

Distribution Requirements — I.R.C. § 72(s). A contract will generally not be treated as an annuity for tax purposes unless, by its terms, it includes rules specified in I.R.C. § 72(s) for distributions in the event of the contract holder's death. Generally, annuity contract forms must be reviewed to determine that the distribution provisions meet the requirements specified in the Code.

CHAPTER SEVEN — FINANCIAL SERVICES REFORM

ETHAN T. JAMES, GREGORY J. LYONS, PAUL L. LEE, SATISH M. KINI AND THOMAS M. KELLY[1]

1. INTRODUCTION AND BACKGROUND

The Gramm-Leach-Bliley Act of 1999 (the "Gramm-Leach-Bliley Act") represented the culmination of many years of intense debate and negotiation among successive Administrations and Congressional leaders, various sectors of the financial services industry, and consumer advocates as to the optimal structure of a new combined banking, insurance and securities industry.

The Gramm-Leach-Bliley Act for the first time permitted affiliation, under a single holding company, of a commercial bank and an insurer, if the holding company qualified as a "financial holding company." The Gramm-Leach-Bliley Act thus ratified the structure of Citigroup, formed by the merger of Citicorp and Travelers in 1998.

The signing of the Gramm-Leach-Bliley Act into law in November of 1999, however, did not set loose a flood of cross-industry mergers or acquisitions, as banks apparently saw little advantage in owning an insurer (the manufacturer) when they could own insurance agencies and brokers (the distributors). This sentiment was best demonstrated in the

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July 2005 sale to MetLife, Inc. of Citigroup's Travelers Life & Annuity and substantially all of Citigroup's international insurance businesses. Citigroup's IPO/spin-off of the shares of its formerly wholly owned subsidiary, Travelers Property Casualty, in 2002, can be interpreted in a similar light. Indeed, MetLife, Inc. has historically been the only major U.S. insurer to utilize the "financial holding company" authority provided by the Gramm-Leach-Bliley Act to acquire a bank.

Nearly five hundred domestic holding companies and foreign banking organizations have elected "financial holding company" status,[2] allowing such entities the freedom to engage in a wide array of activities determined to be "financial in nature or incidental to such financial activity" or "complementary to a financial activity."[3] For domestic bank holding companies that have elected "financial holding company" status, the most likely business opportunities in insurance appear to be presented by the acquisition of insurance agency operations. For foreign banking organizations that have elected "financial holding company" status, the most likely business opportunities in insurance may be presented by foreign insurance acquisitions or affiliations that in the past would have been less attractive because of the need to divest or curtail insurance operations in the United States acquired through the proposed affiliation.

An insurance company or insurance holding company seeking to enjoy the benefits of the Gramm-Leach-Bliley Act to acquire a bank would have to qualify as a "financial holding company." This would require the insurance company or insurance holding company to submit itself to comprehensive regulation by the Board of Governors of the Federal Reserve System (the "Federal Reserve Board"), including capital adequacy requirements for holding companies. Prior to the financial crisis in 2008 and 2009, insurance companies and insurance holding

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[2] As reported on the Federal Reserve Board's website: http://www.federalreserve.gov/generalinfo/fhc/.

[3] See Section 2 of this Chapter.

companies had generally proceeded very cautiously in making the decision to subject themselves to such an extensive federal regulatory regime.

The 2008 and 2009 financial crisis initially prompted a number of financial firms to reconsider the desirability of subjecting themselves to comprehensive federal regulation, if only to gain access to certain forms of federal financial support during the crisis. In September 2008, the two largest investment banking firms in the United States, Goldman Sachs and Morgan Stanley, chose to convert into bank holding companies and financial holding companies. Other major financial firms such as American Express Company also chose to convert to bank holding company status.

Insurance holding companies also carefully considered the potential benefits of submitting to a federal regulatory regime either as a bank holding company or a savings and loan holding company. A significant factor in this calculus in the fall of 2008 was the provision in the Department of the Treasury Capital Purchase Program that limited eligibility for participation in that Program to financial firms that were bank holding companies or savings and loan holding companies. To qualify for eligibility for the Program, several insurance holding companies in the fall of 2008 filed to become either a bank holding company or a savings and loan holding company. Protective Life Corporation was approved to become a bank holding company in January 2009, although it ultimately did not proceed with the acquisition of a bank and did not become a bank holding company. Hartford Financial Services Group and Lincoln National Corporation each were approved in January 2009 to become a savings and loan holding company and each subsequently acquired a "thrift" institution and became a savings and loan holding company. Each of Hartford and Lincoln also received a preferred stock investment from the Department of the Treasury under the Capital Purchase Program. Hartford and Lincoln each repaid the investment to the Department of the Treasury in 2010.

Many of the basic assumptions underlying the existing U.S. regulatory structure were called into question by the financial crisis. In June 2009 the Department of the Treasury issued a White Paper on Financial Regulatory Reform, calling for the reform of significant parts of the existing financial regulatory structure. The Treasury also submitted a draft of proposed legislation to implement the recommendations contained in the White Paper. The Treasury draft provided the basis for legislative action in the House in December 2009 and the Senate in May 2010 on versions of financial reform legislation. The House and Senate versions were reconciled by a Conference Committee of the House and Senate in June 2010, leading to the ultimate enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") in July 2010.

The Dodd-Frank Act represents the most sweeping revision of federal banking laws since the Great Depression. It both expands and reorders the U.S. financial regulatory system. It imposes significant new requirements and restrictions on the regulation and operation of financial companies. Several of its provisions will directly affect the operations of insurance companies and reinsurance companies. In several respects it also modifies or places additional restrictions on the powers provided to financial institutions by the Gramm-Leach-Bliley Act. The effects of the Dodd-Frank Act are already being felt in the insurance and banking sectors. Several large insurers, including Allstate, Lincoln Financial and Hartford have disposed of their thrift subsidiaries in response to the new regulatory environment. Other insurers are in the process of converting their thrift subsidiaries into "limited purpose" trust companies so that they can deregister as savings and loan holding companies. MetLife is in the process of disposing of its bank subsidiaries so that it can deregister as a bank holding company.

At the core of the Dodd-Frank Act lie various provisions designed to address systemic risk in the U.S. financial system. Among the most important provisions of the Dodd-Frank Act in this respect are those which create a new regulatory regime for systemically important financial institutions (commonly referred to as SIFIs). For purposes of

the Dodd-Frank Act, systemically important financial institutions include all bank holding companies ("BHCs") with consolidated assets of $50 billion or more and other large interconnected financial companies, possibly including insurance companies, hedge funds, and other nonbank financial firms. The Dodd-Frank Act creates a new Financial Stability Oversight Council (the "Council") with broad responsibility to monitor and address systemic risk. Among the most important responsibilities of the Council will be the task of designating specific nonbank financial firms that will now be subject to supervision by the Federal Reserve Board as systemically significant financial institutions. A financial company so designated by the Council will be subject to comprehensive supervision by the Federal Reserve Board, including capital, liquidity, risk management and other prudential measures. Such a company will become subject to a set of other requirements, including the requirement to provide prior written notice to the Federal Reserve Board before acquiring voting shares of a company engaged in financial activities having total assets of $10 billion or more. An insurer that has disposed of its bank or thrift subsidiary would still potentially be subject to designation as a SIFI by the Council. Such a designation would subject the insurer to the comprehensive supervision of the Federal Reserve Board, as discussed above.

The Dodd-Frank Act makes a number of other changes to the current regulatory structure, one of the most important being the abolition of the Office of Thrift Supervision (the "OTS"). As a result of the abolition of the OTS, the Federal Reserve Board has succeeded the OTS as the regulator with supervisory responsibility for thrift holding companies. The Federal Reserve Board is expected to be a much more robust regulator of thrift holding companies than the OTS. The Dodd-Frank Act also largely eliminates the provisions for deference to functional regulators of functionally regulated subsidiaries (including insurance subsidiaries) of BHCs established by the Gramm-Leach-Bliley Act. Finally, the so-called Volcker Rule provisions of the Dodd-Frank Act impose very significant restrictions on the ability of financial firms affiliated with an insured depository institution to engage in "proprietary trading" and to sponsor or invest in hedge funds or private equity funds.

The Volcker Rule provisions in effect curtail the powers provided to BHCs under the Gramm-Leach-Bliley Act and extend the restrictions on sponsoring or investing in hedge funds or private equity funds to thrift holding companies and other companies that own or are affiliated with an insured depository institution. These and other provisions of the Dodd-Frank Act, which have significant implications for insurers affiliated with depository institutions, are discussed in the sections below.

2. INSURERS' ROUTES TO BANKING BEFORE GRAMM-LEACH-BLILEY

a. Unitary Thrift Holding Companies

Prior to the Gramm-Leach-Bliley Act, a "unitary thrift holding company" (generally a company that owned only a single insured thrift institution) was generally free to engage in nonfinancial activities and to affiliate with nonfinancial entities in any line of business. Thus, as explained further below, an insurance holding company could not own a commercial bank, but an insurance holding company was free to own a single thrift institution. Many insurers formed thrifts in the years preceding the enactment of the Gramm-Leach-Bliley Act. The Gramm-Leach-Bliley Act effectively closed this opportunity for commercial firms, except for unitary thrift holding companies existing, or formed pursuant to applications filed, on or before May 4, 1999. This grandfathered status is lost if the unitary thrift holding company is acquired by an acquiror that engages in commercial (non-financial) activities.[4] The Dodd-Frank Act preserved the status of grandfathered unitary thrift holding companies,[5] and thus grandfathered unitary thrift holding companies are not generally subject to activities restrictions at

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4 § 401 of the Gramm-Leach-Bliley Act.

5 § § 606(b) & 626 of the Dodd-Frank Act.

the holding company level under the Dodd-Frank Act, although such companies can now be required to establish an intermediate holding company to hold subsidiaries that are engaged in financial activities.[6]

During the legislative process that culminated in Gramm-Leach-Bliley, insurance companies rushed to charter thrifts. For example, in November 1997 the OTS granted thrift charters to Principal Financial Group, a large life insurer, and Travelers, parent of large life and property and casualty insurance subsidiaries. Other insurance-related entities applying for thrift charters in 1997 and 1998 included State Farm Mutual Automobile Insurance Co., American International Group, Inc., AmerUs Group Holdings, CNA Financial, CCC Holdings Inc., The Equitable Companies Inc., GE Financial Services, Grange Mutual Casualty Company, Guardian Mutual Life Insurance Company, The Hartford Group, INA Holdings Corporation, Loews/Lumbermans, Inc., MetLife, the National Association of Mutual Insurance Companies, Nationwide Insurance Enterprise, Shelter Mutual Insurance Company, Sun America Inc., Transamerica Group and Teachers Insurance and Annuity Association of America. According to the OTS, as of the end of May 2001, a total of 33 thrift charters had been granted to insurance companies.

A unitary thrift holding company could (and, post Gramm-Leach-Bliley, a unitary thrift holding company may), itself or through subsidiaries, underwrite and sell all types of insurance on one condition: the thrift it owns must qualify as a "qualified thrift lender" (a "QTL"). A QTL must maintain 65% or more of its investments primarily in housing and consumer assets (including credit card receivables). If the thrift subsidiary fails to meet the QTL test, the holding company must either dispose of the thrift or conform the activities of the thrift to those permissible for a national bank and must itself register as a BHC under the BHC Act. Because a BHC may not engage in general insurance

[6] § 626 of the Dodd-Frank Act. Unitary thrift holding companies are also subject to the Volcker Rule provisions of the Dodd-Frank Act.

agency and underwriting activities, the holding company would also have to qualify as a financial holding company (an "FHC") under the provisions of Gramm-Leach-Bliley to retain its capacity to engage in the broad range of insurance activities. Under the Dodd-Frank Act, a company seeking FHC status must be well capitalized and well managed at the holding company level, as well as at the depository institution level.[7] Under the Dodd-Frank Act, a thrift holding company (other than a grandfathered unitary thrift holding company) will also have to meet the heightened criteria for FHC status if the thrift holding company engages in the broader set of financial activities authorized under the Gramm-Leach-Bliley Act. In addition, thrift holding companies will be subject to capital requirements and to a source-of-strength requirement under the Dodd-Frank Act.[8] As noted above, the heightened capital and other supervisory requirements projected under the Dodd-Frank Act have prompted large insurers to dispose of their bank or thrift subsidiaries.

(1) Thrifts

What is a thrift? A "thrift" is one of several types of institutions chartered and regulated by the individual states or formerly by the OTS (and now the Office of the Comptroller of the Currency (the "OCC")). For purposes of the insurance activities discussed in this Chapter, a thrift is a "savings association" excluded from the definition of "bank" under the Bank Holding Company Act of 1956, as amended (the "BHC Act.")[9] A "savings association" is defined as (i) any federal savings association or federal savings bank, (ii) any building and loan association, savings and loan association, homestead association or

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7 § 606(b) of the Dodd-Frank Act, amending 12 U.S.C. § 1843(l)(1).

8 § 171 of the Dodd-Frank Act; § 616(b) of the Dodd-Frank Act, amending 12 U.S.C. § 1467a(g)(1).

9 12 U.S.C. § 1841 *et seq.*

cooperative bank (if such association or cooperative bank is a member of the Savings Association Insurance Fund), and (iii) any other savings bank or cooperative bank deemed by the OTS to be a savings association under the Home Owners' Loan Act.[10] The Dodd-Frank Act mandates that the Comptroller General conduct a study on whether excluding thrifts from the BHC Act definition remains a desirable policy choice.[11] The study was released in January of 2012.[12]

The stated purpose of a thrift charter is to provide consumer oriented banking services. Thrifts may engage in many activities similar to national banks. However, they may not engage in unlimited commercial banking activities. As discussed above, thrifts must allocate at least 65% of their assets to residential mortgage loans and other loans to consumers and small businesses.

The regulatory framework created by the Dodd-Frank Act abolishes the OTS and transfers its authority to the other federal banking agencies, with the Federal Reserve Board gaining supervisory authority over thrift holding companies, the OCC gaining supervisory authority over federal thrifts and general rulemaking authority (subject to certain exceptions) over all thrifts, and the Federal Deposit Insurance Corporation (the "FDIC") gaining supervisory authority over state thrifts.[13]

(2) Unitary Thrift Holding Companies

A unitary thrift holding company is a company that directly or indirectly acquires 25 percent or more of the voting shares of a single thrift or

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10 12 U.S.C. § 1841(j).

11 § 603(b) of the Dodd-Frank Act.

12 Government Accountability Office, *Bank Holding Company Act: Characteristics and Regulation of Exempt Institutions and the Implications of Removing the Exemptions* (Jan. 2012).

13 12 U.S.C. § 5411.

otherwise controls the election of a majority of the thrift's board of directors. A grandfathered unitary thrift holding company is not subject to the nonbanking limits in the BHC Act. These limits, as discussed below, restrict affiliations between bank holding companies (that do not elect to qualify as FHCs) and insurance companies.

(3) Permissible Insurance Activities of Thrifts and Their Affiliates

A thrift operating under a federal charter does not have the express power to engage in any insurance-related activities under federal law. (The rules may differ for state-chartered thrifts.) However, the OTS has determined that a thrift may act as an agent in the sale of credit-related insurance and fixed annuities, as an incident to its expressly granted powers.

b. Service Corporations

A federal savings association may invest up to 3% of its assets in a subsidiary service corporation. A service corporation is permitted to engage in the same activities, including those related to insurance, as the parent thrift. Additionally, the subsidiary may act as an agent or broker for liability, casualty, automobile, life, health, accident or title insurance, without geographic limitation. With OTS (now OCC) approval, the subsidiary also may underwrite or reinsure credit insurance.

c. Limited Purpose Trust Companies

Under federal banking law, an insurance company may acquire or establish a "limited purpose trust company."[14] If the trust company functions "solely in a trust or fiduciary capacity" (and meets certain

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[14] 12 U.S.C. § 1841(c)(2)(D).

other technical requirements), it is excluded from the definition of a "bank" under the BHC Act. Therefore, its acquisition by an insurance company does not trigger the nonbanking restrictions of the BHC Act.

A company is a limited purpose trust company if:

- all or substantially all of the deposits of such institution are in trust funds and are received in a *bona fide* fiduciary capacity;
- no deposits of such institution which are insured by the FDIC are offered or marketed by or through an affiliate of such institution;
- it does not accept demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or make commercial loans; and
- it does not obtain payment or payment-related services from any Federal Reserve bank, including any service referred to in section 11A of the Federal Reserve Act, or exercise discount or borrowing privileges pursuant to section 19(b)(7) of the Federal Reserve Act.[15] The services under Section 11A consist of: (i) currency and coin services; (ii) check clearing and collection services; (iii) wire transfer services; (iv) automated clearinghouse services; (v) settlement services; (vi) securities safekeeping services; (vii) Federal Reserve float; and (viii) any new services which the Federal Reserve System offers, including but not limited to payment services to effectuate the electronic transfer of funds.

As mentioned previously, the Dodd-Frank Act mandates that the Comptroller General conduct a study on whether safety and soundness concerns justify the elimination of the thrift exemption from the BHC Act. The Dodd-Frank Act also mandates that the Comptroller General examine the same question with respect to credit card banks, industrial

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15 12 U.S.C. § 1841(c)(2)(D)(iv).

banks, and limited purpose trust companies.[16] The Comptroller General's study, which was published in January of 2012, concluded that although the implications of eliminating the exemption for these institutions varied, data suggested that removal of the exemptions would have a limited overall impact on U.S. credit markets.[17] In addition, the Dodd-Frank Act amends the Home Owners' Loan Act to exclude limited purpose trust companies from the category of thrift holding companies.[18]

d. Nonbank Banks

There are three categories of nonbank banks that an insurance company or insurance holding company may own. Each type relies on an exclusion from treatment as a "bank" under the BHC Act, albeit under different circumstances.

The most commonly discussed is a "grandfathered" nonbank bank, formed prior to 1987. A grandfathered nonbank bank engaged in activities just short of those that would trigger treatment as a "bank" under the BHC Act. Prior to 1987, a bank was defined as an institution that "both accepts demand deposits or deposits that the depositor may withdraw by check or similar means … and is engaged in the business of making commercial loans." Grandfathered nonbank banks accepted deposits other than demand deposits, and were able to obtain FDIC insurance. (Others, for example, only made consumer loans.)

This definition of "bank" permitted a nonbanking company, such as an insurance company, to own an entity with many competitively important

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16 § 603(b) of the Dodd-Frank Act.

17 Government Accountability Office, *Bank Holding Company Act: Characteristics and Regulation of Exempt Institutions and the Implications of Removing the Exemptions* (Jan. 2012).

18 § 604(i) of the Dodd-Frank Act, amending 12 U.S.C. § 1467a(a)(1)(D)(ii).

banking powers (not least of which was FDIC insurance). In 1987, Congress closed the so-called nonbank bank loophole. In so doing, however, Congress grandfathered existing nonbank banks by granting their parent companies an exemption from treatment as bank holding companies. Any insurance company (or commercial enterprise) that owned a nonbank bank prior to March 5, 1987 was able to retain its banking affiliate.

A grandfathered nonbank bank was subject to many restrictions, however. For example, in the years preceding the Gramm-Leach-Bliley Act, it could not expand its activities beyond those conducted in 1987 or increase its assets at an annual rate greater than 7% during any 12-month period. Cross-marketing of products that a bank holding company could not offer was also prohibited. Many of these restrictions were lifted by the Gramm-Leach-Bliley Act.[19] Nevertheless, pursuant to the Gramm-Leach-Bliley Act, if a grandfathered nonbank bank starts accepting demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties and engages in the business of making commercial loans (excluding loans made in the ordinary course of a credit card operation), then the holding company that owns this bank risks becoming a bank holding company through the loss of its exemption under the BHC Act. The same result awaits the grandfathered nonbank bank holding company in the event that its bank subsidiary permits any overdraft or incurs any such overdraft in the account of the bank at a Federal Reserve bank, on behalf of an affiliate, other than certain permissible overdrafts specified in the BHC Act.[20]

Furthermore, an insurance company may continue to own a grandfathered nonbank bank as long as it is not acquired by another company and does not acquire more than 5% (or in some cases, with

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[19] § 107(a) of the Gramm-Leach-Bliley Act, amending 12 U.S.C. § 1843(f)(3).

[20] § 107(d)(3) of the Gramm-Leach-Bliley Act, amending 12 U.S.C. § 1843(f)(2).

regard to a thrift, 15%) of the shares or assets of an additional bank or a thrift. If the insurance company is acquired, or seeks to acquire an additional bank or a thrift, either the acquirer will not be eligible for the exemption permitting it to control the nonbank bank, or the insurance company will lose its grandfather rights. Either event will cause the insurance company to become a bank holding company, a result that is prohibited under the BHC Act, unless the insurance company also qualifies as an FHC.

The second type of nonbank bank has its roots in the same rationale that created its grandfathered kin. This type of nonbank bank (formed after 1987) also limits its activities to avoid treatment as a "bank" under federal banking law, but cannot obtain FDIC insurance for its deposits. Although an insurance company may currently form such a nonbank bank without becoming subject to the BHC Act, other narrowing interpretations of the definition of bank and requirements under state law to obtain FDIC insurance make this option commercially unattractive.

The third type of nonbank bank is a creature of the banking law in several states (most prominently Utah) that permit the organization of a so-called industrial loan company or industrial bank and that as of 1987 required such institutions to obtain FDIC insurance. These institutions typically have broad powers to engage in banking activities under state law, but to qualify for the exemption from the BHC Act the institution must either (i) not accept demand deposits or (ii) limit its asset size to less than $100 million.

A number of leading commercial as well as financial firms have organized industrial loan companies or industrial banks. The announcement by Wal-Mart in July 2005 that it had filed for approval to organize an industrial bank in Utah brought renewed attention to this phenomenon. In the face of substantial opposition, Wal-Mart eventually withdrew its application and in July 2006 the FDIC imposed a moratorium on the approval of the acquisition of control of industrial loan companies or industrial banks by companies engaged in non-financial activities.

The Dodd-Frank Act instituted two noteworthy changes with respect to nonbank banks. First, the FDIC may not approve an application for deposit insurance from a nonbank bank otherwise exempt from the BHC Act, if that nonbank bank is directly or indirectly controlled by a commercial firm.[21] Second, the Dodd-Frank Act imposes a moratorium on changes in control that would result in a commercial firm acquiring direct or indirect control of a nonbank bank, unless (i) the nonbank bank is in danger of default as determined by the appropriate federal banking agency, (ii) the change in control results from the merger or "whole acquisition" of a commercial firm that controls a limited purpose bank, or (iii) the change in control results from an acquisition of voting shares of a publicly traded trust company that controls a nonbank bank, if, after the acquisition, the acquirer holds less than 25% of any class of voting shares.[22] Both provisions sunset three years after the Dodd-Frank Act's date of enactment.[23]

3. BANKING AND INSURANCE UNDER A FINANCIAL HOLDING COMPANY

Under the BHC Act, as amended by the Gramm-Leach-Bliley Act, a company may own both a bank and an insurance company if the company qualifies as an FHC.

a. Bank Holding Companies Eligible to Qualify as Financial Holding Companies

BHCs meeting the criteria set forth in the Gramm-Leach-Bliley Act may elect, pursuant to Section 103(a) of the Gramm-Leach-Bliley Act, to be treated as FHCs. An FHC is a type of entity under the BHC Act that is

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[21] § 603(a)(2) of the Dodd-Frank Act.

[22] § 603(a)(3) of the Dodd-Frank Act.

[23] § 603(a)(4) of the Dodd-Frank Act.

permitted to engage in activities, and acquire companies engaged in activities, that are "financial" in nature or "incidental" or "complementary" to such financial activities. In order to qualify as an FHC, each depository institution subsidiary of the BHC must be well managed and well capitalized and each insured depository institution subsidiary must have received at least a "satisfactory" Community Reinvestment Act rating as of its most recent examination. A qualified BHC that chooses to become an FHC must file a certification to that effect with the Federal Reserve Board.[24] Thereafter, if any depository institution subsidiary of the BHC fails to remain well-managed and well capitalized, the Federal Reserve Board will have the authority to require the BHC to divest the depository institution in question or otherwise to conform its activities to those that are permissible for BHCs that are not FHCs, unless the FHC submits a plan acceptable to the Federal Reserve Board to correct the deficiency within a specified period of time. Restrictions on activities of the FHC may be applied by the Federal Reserve Board during this period. Similarly, if any insured depository institution subsidiary of an FHC fails to maintain a satisfactory Community Reinvestment Act rating, the FHC may not commence new activities that are "financial in nature" until the insured depository institution regains a satisfactory rating.

BHCs that do not become FHCs remain by default subject to the activity restrictions under Section 4(c)(8) of the BHC Act, which limit BHCs to ownership of subsidiaries engaged in lines of business deemed "closely related to banking." Moreover, Section 4(c)(8) and the Federal Reserve Board's regulations and interpretations thereunder were "frozen" by Section 102(a) of the Gramm-Leach-Bliley Act, so that BHCs continuing under the old regime could find it difficult or impossible to push the envelope and grow into new areas of business. See Section 3.c of this Chapter. Under the Dodd-Frank Act, BHCs that currently qualify as FHCs or that seek to become FHCs are now

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[24] 12 C.F.R. § 225.82.

required to maintain well capitalized and well managed status at the holding company level as well as at the depository institution level.[25]

b. Insurance Activities of Financial Holding Companies

FHCs are allowed, directly or through subsidiaries, to act as principal, agent or broker in selling life, P&C and other forms of insurance, including annuities. This is in addition to the limited insurance activities already authorized for BHCs but, as is the case for national bank insurance sales, solicitation and cross-marketing activities, subject largely to state law restrictions. See Section 4.a of this Chapter.

Further, the Federal Reserve Board and the Treasury Department have authority to expand the list of activities deemed to be "financial in nature or incidental thereto." In order to foster cooperation between the Federal Reserve Board and the Treasury Department in making such determinations and minimize opportunities for regulatory arbitrage, the Treasury Department may veto proposals by the Federal Reserve Board to authorize new activities for FHCs and their nonbank subsidiaries. Exercise of such a veto, however, would have the effect of precluding financial subsidiaries of national banks from engaging in those activities. Conversely, the Federal Reserve Board is given the right to veto proposals by the Treasury Department to authorize new activities of financial subsidiaries of national banks, with corresponding implications for FHCs and their nonbank subsidiaries. However, the symmetry is not perfect. Only the Federal Reserve Board has the right to approve new activities deemed to be "complementary" to financial activities, without threat of a veto by the Treasury Department. Under the Gramm-Leach-Bliley Act, complementary activities can be conducted only by FHCs and their nonbank subsidiaries, but not by financial subsidiaries of a national bank.

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[25] § 606(a) of the Dodd-Frank Act, amending 12 U.S.C. § 1843(l)(1).

Under the Gramm-Leach-Bliley Act, FHCs were generally free to acquire companies engaged in, or to commence conducting, activities which are "financial," or incidental or complementary thereto, without having to obtain advance approval from the Federal Reserve Board. The Federal Reserve Board merely had to be given notice not later than 30 days *after* such an acquisition or commencement of a permissible activity.[26] The Dodd-Frank Act, however, imposes a new restriction on FHC acquisition activity. The Board must grant *prior* approval for an FHC acquisition of a nonbank company if the assets to be acquired in the transaction exceed $10 billion.[27]

c. Existing Insurance Activities of Bank Holding Companies

Section 102(a) of the Gramm-Leach-Bliley Act amended Section 4(c)(8) of the BHC Act to provide that BHCs may engage in nonbanking activities in the United States that were deemed by the Federal Reserve Board as of the day before the date of the enactment of the Gramm-Leach-Bliley Act "to be so closely related to banking as to be a proper incident thereto." Prior to the Gramm-Leach-Bliley Act, Section 4(c)(8) had expressly stated that providing insurance as "principal, agent or broker" was not an activity closely related to banking, and such activities were therefore not generally permissible for BHCs, subject to several narrow specified exceptions. As noted above, however, the regulations and orders of the Federal Reserve Board, issued pursuant to Section 4(c)(8), have essentially been "frozen" by Section 102(a) of the Act. The insurance activities that a BHC is permitted to conduct under Section 4(c)(8), subject to certain state law restrictions, may be summarized as follows:

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[26] 12 C.F.R. § 225.87(a).

[27] § 604(e)(2)(ii) of the Dodd-Frank Act, amending 12 U.S.C. § 1843(k)(6)(B).

- **Credit health, life and unemployment insurance**. A BHC may underwrite or sell as agent insurance that is directly related to credit extended by that BHC or its subsidiaries. This insurance must be limited to ensuring the "repayment of the outstanding balance due on the extension of credit [by a BHC or its subsidiary] in the event of the death, disability, or involuntary unemployment of the debtor."[28]

- **Credit-related property insurance**. A BHC may sell as agent insurance that is directly related to small credits issued by its finance company subsidiary. This insurance must be limited to ensuring the "repayment of the outstanding balance on such extension of credit in the event of loss or damage to any property used as collateral for the extension of credit" and the credit must not exceed $10,000 (or $25,000 if it provides a mortgage for the purchase of a manufactured home), subject to indexation based on the Consumer Price Index.[29]

- **Sale as agent from a small town**. A BHC may perform any insurance agency activity from a place with a population of 5,000 or less (or which otherwise has inadequate insurance agency facilities, as determined by the Federal Reserve Board). To use this exemption a BHC or one of its subsidiaries must have a lending office in the small town.[30]

- **Other**. Other rules adopted by the Federal Reserve Board pursuant to the BHC Act permit a BHC to, among others, supervise retail insurance agents on behalf of other insurance underwriters who sell certain types of insurance to or for the BHC, its subsidiaries or its employees.[31]

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[28] 12 C.F.R. § 225.28(b)(11)(i)(B).

[29] 12 C.F.R. § 225.28(b)(11)(ii).

[30] 12 C.F.R. § 225.28(b)(11)(iii).

[31] 12 C.F.R. § 225.28(b)(11)(v).

d. Non-Financial Activities of Financial Holding Companies

Under the Gramm-Leach-Bliley Act, FHCs are authorized to engage in certain merchant banking activities. FHCs are permitted to acquire or control up to 100% of the voting and other ownership interests of any company, regardless of whether that company's business or activities are financial in nature, subject to the following conditions:[32]

- such interests may not be held by a depository institution or a subsidiary thereof;
- such interests may only be held by the FHC through:
  - (x) a securities affiliate (or an affiliate of such a securities affiliate) of an FHC, or (y) an investment adviser affiliate (or an affiliate of such investment adviser affiliate) of an insurance company that underwrites life, accident and health, or property and casualty insurance (other than credit-related insurance) or provides and issues annuities, and then only "for a period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability of the activities"; or
  - an insurance company that underwrites life, accident and health, or property and casualty insurance (other than credit-related insurance) or provides and issues annuities, and then only to the extent such interests represent an investment made in the ordinary course of its business in accordance with relevant state law (but without any statutory limit on the holding period); and
- during the period in which such interests are held by the FHC, the FHC may not "routinely manage or operate" the company in question, "except as may be necessary or required to obtain a

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[32] 12 U.S.C. § 1843(k)(4)(H) & (I).

> reasonable return on investment [upon resale or disposition[33]]" (although having and exercising outright "control" is permitted).

The distinction between exercising control and becoming involved in "routine" management or operations of a portfolio company represented a significant departure from the Federal Reserve Board's prior approach under its so-called "stakeout guidelines," under which investments in otherwise impermissible businesses had to be strictly "passive" in nature, even at the expense of depriving the bank holding company of normal and customary protections for private equity investors. Before the Dodd-Frank Act, the statutory language appeared broad enough to open the door for FHCs to become full participants in the business of organizing, marketing, managing and investing in private equity funds and to allow an insurance holding company to remain in these businesses after acquiring a bank. Further, insurance companies that held such interests were not necessarily subject to a holding period limitation, since state law applied.

Insurance companies are the FHC subsidiaries that have the greatest flexibility to make venture capital and merchant banking investments in non-financial businesses. However, the insurer would need to have a significant volume of insurance business and a large and diversified investment portfolio in order to make a significant volume of private equity investments. The principal constraints will be state insurance legal investment laws, which vary from state to state. An insurer must comply with the legal investment laws of its state of domicile and, if it is licensed in New York, must comply substantially with the New York law that would apply to a comparable insurer domiciled in New York.

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[33] The words "upon resale or disposition" appear in 12 U.S.C. § 1843(k)(4)(H)(iv) in connection with the management or operation of companies held by the FHC's securities or investment adviser affiliates, but not in 12 U.S.C. § 1843(k)(4)(I)(iv), in connection with the management or operation of companies held by the FHC's insurance companies.

Such laws generally impose limits, as a percentage of total admitted assets, on the amount an insurer may invest in any single issuer, the amount the insurer may invest in equities and the amount the insurer may invest in subsidiaries. Investments in excess of the limits do not count as admitted assets (for purposes of financial regulation of the insurer), and the domestic regulator often has the power to order divestiture of investments that exceed the limit.

The Federal Reserve Board and the Treasury Department issued joint regulations, implementing the new authority to engage in merchant banking activities granted by the Gramm-Leach-Bliley Act. As contemplated by the Gramm-Leach-Bliley Act, in particular, these regulations include restrictions and limitations on the relationship between a financial holding company and its affiliated portfolio companies.[34]

e. The Volcker Rule

Among the new restrictions on financial holding company activity under the Dodd-Frank Act, the so-called "Volcker Rule"[35] is one of the most important. The Volcker Rule prohibits any "banking entity" from (i) engaging in proprietary trading; or (ii) acquiring, sponsoring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund.[36] As defined in the Dodd-Frank Act, "banking entities" include virtually all insured banks or thrifts, the companies that control them, their affiliates and subsidiaries, and foreign banks with a U.S. banking presence.[37] "Hedge funds" and "private equity funds" include issuers that would be "investment companies" as defined in the

[34] 12 C.F.R. § 225.170-177.

[35] § 619 of the Dodd-Frank Act, amending 12 U.S.C. § 1851.

[36] § 619(a) of the Dodd-Frank Act, amending 12 U.S.C. § 1851.

[37] § 619(h)(1) of the Dodd-Frank Act, amending 12 U.S.C. § 1851.

Investment Company Act of 1940, but for § 3(c)(1) or 3(c)(7) of that Act.[38] The Dodd-Frank Act contains certain specific exceptions to these prohibitions.[39]

The relevant regulatory agencies have jointly proposed implementation rules for the Volcker Rule. The Proposed Volcker Implementation Rules, among other things, propose definitions for key terms, statutory and non-statutory exemptions, and detailed and complex policies and procedures.[40] The release proposing the Proposed Volcker Implementation Rules includes almost 400 questions requesting comment on a range of issues, suggesting both that the Proposed Volcker Implementation Rules are a work in progress and that the regulators have not achieved consensus on many of the elements of the proposal. The summary below highlights the most significant aspects relating to insurance companies.

Under the Proposed Volcker Implementation Rules, an insurance company (and any affiliate of an insurance company) is not subject to the ban on proprietary trading if (i) the insurance company is directly engaged in the business of insurance and subject to regulation by a U.S. state insurance regulator or a non-U.S. insurance regulator; (ii) the trading is solely for the general account of the insurance company; (iii) the trading is conducted in compliance with, and subject to, relevant insurance company investment laws; and (iv) the relevant regulatory agency (in consultation with FSOC and after notice and comment) has not made a determination that this exemption should not be available because it is insufficient to protect the safety and soundness of the

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38 § 619(h)(2) of the Dodd-Frank Act, amending 12 U.S.C. § 1851.

39 § 619(d) of the Dodd-Frank Act, amending 12 U.S.C. § 1851.

40 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (Nov. 7, 2011)) (Interagency Proposal) [hereinafter Proposed Volcker Implementation Rules].

insurance company or of the financial stability of the United States.[41] The definition of "general account" under the Proposed Rules includes all of the assets of the insurance company that are not legally segregated and allocated to separate accounts under applicable U.S. state or non-U.S. law.[42]

There is also an exemption from the propriety trading ban under the Proposed Volcker Implementation Rules for any transactions by an insurance company "on behalf of customers" in a separate account if (i) the insurance company is directly engaged in the business of insurance and subject to regulation by a U.S. state insurance regulator or non-U.S. insurance regulator; (ii) the transactions are solely for a separate account established by the insurance company in connection with one or more insurance policies issued by that insurance company; (iii) all profits and losses arising from the transactions are allocated to the separate account and inure to the benefit or detriment of the owners of the insurance policies supported by the separate account, and not the insurance company; and (iv) the transactions are conducted in compliance with, and subject to, the relevant insurance company investment and other laws.[43] Under the Proposed Volcker Implementation Rules, "separate account" means an account established and maintained by an insurance company subject to regulation by a U.S. state insurance regulator or a foreign insurance regulator under which income, gains and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.[44]

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41 Proposed Volcker Implementation Rules § ___.6(c).

42 *Id.* at § ___.3(b)(5).

43 Id. at § ___.6(b)(2)(iii).

44 Id. at § ___.2(z).

The Proposed Volcker Implementation Rules do not provide exemptions with respect to investments in covered funds equivalent to the general account and separate account exemptions from the proprietary trading ban. Various industry comment letters have asserted that the statutory exemption from the Volcker Rule's general prohibition for insurance company investment activities conducted for the general account of an insurance company[45] (the "General Account Exemption") applies to investments in covered funds by the general account. These comment letters have also asserted that the statutory exemption from the Volcker Rule's general prohibitions for investment activities conducted "on behalf of customers"[46] (the "Separate Account Exemption") applies to investments in covered funds by separate accounts offered and maintained by an insurance company.

4. NATIONAL BANKS

a. Insurance Activities of National Banks Under the Gramm-Leach-Bliley Act

The Gramm-Leach-Bliley Act added no new insurance powers for national banks. It also generally did not, with certain exceptions discussed below, rescind national bank insurance powers already in effect as of January 1, 1999.

Section 303 of the Gramm-Leach-Bliley Act prohibits national banks from underwriting or selling title insurance, but allows for two principal exceptions: national banks are permitted (i) to sell title insurance as agent if state banks in the State in which they are operating are authorized to do so as well, and (ii) to continue underwriting title insurance if they were doing so prior to enactment of the Gramm-

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45 § 619(d)(1)(F) of the Dodd-Frank Act, amending 12 U.S.C. § 1851.

46 § 619(d)(1)(D) of the Dodd-Frank Act, amending 12 U.S.C. § 1851.

Leach-Bliley Act. However, the grandfathering clause is limited to institutions that lack an alternative platform for delivery of title insurance underwriting services. If the bank's holding company or a holding company affiliate underwrites any type of insurance, then title insurance underwriting must be moved to the holding company level. Moreover, if the national bank has a subsidiary engaged in any type of insurance underwriting, then the national bank is denied the right to directly engage in title insurance underwriting. Sections 302(a) and (b)(3) also formally end the power of national banks to underwrite the controversial Retirement CD (a formerly tax-deferred annuity-like product marketed by Blackfeet National Bank under license from American Deposit Corp.) and similar products. More importantly, Section 302(a) of the Gramm-Leach-Bliley Act curtails the ability of the OCC to expand further the insurance underwriting powers of national banks by generally limiting national bank insurance underwriting to "authorized products." An insurance product is "authorized" if, as of January 1, 1999, the OCC had permitted national banks to sell it as principal or national banks were otherwise lawfully doing so, and no court had overturned any such OCC authorization. For purposes of the underwriting restrictions of the Gramm-Leach-Bliley Act, "insurance" means, in any state, (i) any product regulated as insurance by such state as of January 1, 1999, (ii) any product so designated after January 1, 1999, in accordance with Section 302(c)(2) of the Gramm-Leach-Bliley Act (which sets forth guidelines for determining whether a product may be deemed to be insurance), or (iii) any annuity contract, the income on which is subject to tax treatment under Section 72 of the Internal Revenue Code of 1986 (the Retirement CD). Thus, aside from the revocation of the powers to sell, as principal, title insurance and the Retirement CD, the Gramm-Leach-Bliley Act essentially froze the insurance underwriting powers of national banks.

With respect to national bank insurance agency activities, the Gramm-Leach-Bliley Act is more generous. National banks may continue to sell

insurance as agent subject to licensing requirements of the states.[47] The McCarran-Ferguson Act, which affirms the power of the states to regulate the insurance business, is specifically reaffirmed.[48] The Gramm-Leach-Bliley Act preempts state laws that prohibit affiliations between depository institutions and insurance companies[49] and that prohibit a depository institution or its affiliate from engaging in insurance sales.[50] However, the Gramm-Leach-Bliley Act creates some ambiguity by grandfathering state laws regarding insurance sales, solicitations and cross-marketing restrictions that were in effect before September 3, 1998,[51] while at the same time reaffirming the applicability of the ruling in *Barnett Bank of Marion County N.A. v. Nelson*,[52] which prohibits state insurance regulators from preventing or significantly interfering with the ability of a depository institution or its affiliates to engage in insurance sales, solicitations or cross-marketing activities.

The Dodd-Frank Act provides that national bank and federal thrift preemption determinations as to State consumer financial laws will be made in accordance with the "prevents or significantly interferes" standard of *Barnett Bank*,[53] and that the OCC must make case-by-case preemption determinations with respect to particular consumer financial laws (or other state laws with substantially equivalent terms).[54] Such preemption will no longer apply to operating subsidiaries (or other affiliates or agents) of national banks that are not themselves national

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[47] § 104(b) of the Gramm-Leach-Bliley Act.

[48] § 104(a) of the Gramm-Leach-Bliley Act.

[49] § 104(c)(1) of the Gramm-Leach-Bliley Act.

[50] § 104(d)(2)(A) of the Gramm-Leach-Bliley Act.

[51] § 104(d)(2)(C) of the Gramm-Leach-Bliley Act.

[52] 517 U.S. 25 (1996).

[53] § 1044(b)(1)(B) of the Dodd-Frank Act, amending 12 U.S.C. § 21 *et seq.*

[54] *Id.*

banks.[55] The Dodd-Frank Act also makes preemption standards for federal thrifts the same as those for national banks.[56]

b. Existing Insurance Activities of National Banks

National banks derive their authority to engage in insurance activities from two sources. Under Section 92 of the National Bank Act, a national bank may sell as agent any type of insurance from an office located in a place with 5,000 or fewer inhabitants.[57] The second source arises from a national bank's power to engage in activities that are "incidental to the business of banking" pursuant to Section 24 (Seventh) of the National Bank Act.[58] The OCC generally determines if this standard is met by applying a three-part test. This test measures whether the activity: (i) is "functionally equivalent to or a logical outgrowth of" the business of banking; (ii) responds to the needs of bank customers, or "otherwise benefits the bank or its customers"; and (iii) involves risks "similar in nature to those already assumed by banks."[59] This second source of power is, as noted above, now severely hampered by Section 302 of the Gramm-Leach-Bliley Act, which extinguishes the OCC's future ability to permit additional national bank insurance underwriting activities. Section 302(c)(2) carves out certain products traditionally in the realm of banking but, given the increasingly complex and hybrid nature of financial products, is candidate to be a rich source of future litigation.

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[55] § 1045 of the Dodd-Frank Act, amending 12 U.S.C. § 25(b).

[56] § 1046 of the Dodd-Frank Act, amending 12 U.S.C. § 1465.

[57] 12 U.S.C. § 92.

[58] 12 U.S.C. § 24 (Seventh).

[59] OCC Interpretive Let. No. 743, Fed. Banking L. Rep. (CCH) ¶ 81-108 (Oct. 17, 1996).

This statutory and interpretive authority has allowed national banks to perform insurance-related activities in the following primary areas:

- **Sale as agent from a place of 5,000 or less**. A national bank located and doing business in a place with a population of 5,000 or less is permitted to act as an "agent for any fire, life or other insurance company."[60] The OCC has defined certain general principles for national banks to follow when relying on this exemption. The bank's insurance agency in the place must: (i) keep its business records there, including insurance policies and applications; (ii) manage and pay insurance agents from the place of 5,000; (iii) collect in the place of 5,000 commissions, premiums and all documentation on behalf of the insurance company; and (iv) deliver all insurance policies from the place of 5,000.[61]

  If these principles are met, the insurance agency may solicit sales from customers located inside or outside the place of 5,000. Under a 1996 OCC ruling, this includes meeting with and soliciting customers and distributing advertisements and brochures outside the place of 5,000.[62] The insurance agency may also sell insurance through satellite offices located outside the place of 5,000 where it is located.[63] In 1999, the OCC expanded this ruling to allow an insurance agency located in a

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60 12 U.S.C. § 92; 12 C.F.R. § 7.1001.

61 OCC Interpretive Let. No. 753, Fed. Banking L. Rep. (CCH) ¶ 81-107 (Nov. 4, 1996).

62 *Id.*

63 OCC Interpretive Let. No. 844, Fed. Banking L. Rep. (CCH) ¶ 81-299 (Oct. 20, 1998).

place of 5,000 to sell insurance through satellite offices located in other States as well.[64]

- **Credit-related insurance**. A national bank may underwrite and sell credit life insurance to customers borrowing from that bank.[65] It also may sell vendor's single interest insurance and credit involuntary unemployment insurance that covers an outstanding loan.[66] Finally, a national bank has also been authorized to enter into debt cancellation contracts and debt suspension agreements.[67]

- **Other types of insurance and related activities**. A national bank also may underwrite and sell municipal bond insurance,[68] sell cancer insurance to credit card customers,[69] collect rent based upon the agent's volume of sales or gross income,[70] and

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64 OCC Interpretive Let. No. 864, Fed. Banking L. Rep. (CCH) ¶ 81-358 (May 19, 1999) (Illinois and Michigan) and OCC Interpretive Let. No. 874, Fed. Banking L. Rep. (CCH) ¶ 81-368 (Dec. 1, 1999) (New York).

65 12 C.F.R. § 2.1.

66 OCC Interpretive Let. No. 283, Fed. Banking L. Rep. (CCH) ¶ 85-447 (Mar. 16, 1984).

67 12 C.F.R. § 37. For examples of recent applications by the OCC of the rules governing debt cancellation contracts, *see* OCC Interpretive Let. No. 1028, Fed. Banking L. Rep. (CCH) ¶ 81-557 (May 9, 2005) and OCC Interpretive Let. No. 1032, Fed. Banking L. Rep. (CCH) ¶ 81-561 (June 16, 2005).

68 OCC Interpretive Let. No. 338, Fed. Banking L. Rep. (CCH) ¶ 85-508 (May 2, 1985).

69 OCC Interpretive Let. No. 316, Fed. Banking L. Rep. (CCH) ¶ 85-486 (Dec. 28, 1984).

70 OCC Interpretive Let. No. 274, Fed. Banking L. Rep. (CCH) ¶ 85-438 (Dec. 2, 1983).

provide a finder's service for bringing sellers and customers of insurance together for a fee.[71]

- **Non-insurance products**. Litigation has centered on whether certain insurance-like products should continue to be classified as insurance for purposes of federal banking law. The OCC has won a significant victory for national banks (and other banking organizations, including BHCs) in this arena with respect to the treatment of annuities. The holder of an annuity contract pays a sum of money for the right to a future stream of fixed or variable payments for a specified term, which may be the life of the contract holder. In 1995, the Supreme Court agreed with the OCC's interpretation that fixed and variable annuity contracts are financial investment instruments, not insurance, and as such could be sold by a national bank, as agent, from any location as an activity incidental to the business of banking. In *NationsBank of North Carolina N.A. v. Variable Annuity Life Ins. Co.*,[72] the Variable Annuity Life Insurance Company challenged a ruling of the OCC permitting NationsBank to sell as agent variable annuity contracts from a branch not located in a small town. The Court upheld the OCC's position that annuities are distinguishable from life insurance because they provide payments over a specified period that is not necessarily related to the length of the policyholder's life and do not necessarily involve mortality risk.

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[71] 12 C.F.R. § 7.1002.

[72] 513 U.S. 251 (1995).

5. SUBSIDIARIES OF NATIONAL BANKS

a. Insurance Activities of National Bank Subsidiaries Under the Gramm-Leach-Bliley Act

The Gramm-Leach-Bliley Act authorized the creation of a financial subsidiary of a national bank to broaden the range of financial activities to which national banks may have access. Under Section 121(a)(2) of the Gramm-Leach-Bliley Act, such a financial subsidiary is allowed to engage in insurance activities and activities incidental thereto, subject to several restrictions:

- the subsidiary may *underwrite* insurance only to the extent permitted for a national bank (see Section 3 of this Chapter);
- the parent national bank, and its affiliated depository institutions, must be well-managed and well capitalized;
- the aggregate consolidated total assets of all financial subsidiaries of the national bank must not exceed the lesser of $50 billion (subject to indexation) and 45% of the consolidated total assets of the parent bank; and
- the parent bank (if one of the 100 largest insured banks) must satisfy certain credit-rating criteria.

In determining a parent bank's compliance with capital adequacy requirements, its equity investment, including retained earnings, in its financial subsidiaries must be excluded from its assets and tangible equity and the assets and liabilities of its financial subsidiaries may not be consolidated with those of the parent bank. In other words, the parent bank would have to remain well capitalized even if its investments in financial subsidiaries were written off in their totality.

Transactions between a bank and its financial subsidiaries will generally be subject to the restrictions on covered transactions (including

extensions of credit) between banks and their affiliates under Sections 23A and 23B of the Federal Reserve Act,[73] which the Dodd-Frank Act enhances in three important respects. First, the definition of "covered transaction" has expanded to include credit exposure on derivatives transactions, as well as securities borrowing and lending transactions.[74] Second, any investment fund that is advised by a bank or an affiliate of the bank is now treated as an affiliate of that bank for purposes of 23A and 23B.[75] Third, exceptions under 23A for transactions with financial subsidiaries have been prospectively eliminated.[76]

b. Existing Insurance Activities of National Bank Subsidiaries

Subsidiaries of national banks generally have the authority to exercise all of the insurance powers of national banks (see Section 3 of this Chapter), including any powers approved by the OCC as of January 1, 1999 for national banks.[77]

6. FOREIGN BANKS

The Gramm-Leach-Bliley Act is important to non-U.S. banks and bancassurance enterprises that are considering a direct or indirect entry into the U.S. insurance industry.

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73 The OCC's related regulations concerning national bank financial subsidiaries appear in 12 C.F.R. § 5.39.

74 § 608(a) of the Dodd-Frank Act, amending 12 U.S.C. § 371(c).

75 *Id.*

76 § 609 of the Dodd-Frank Act, amending 12 U.S.C. § 371(c)(e).

77 The OCC's related regulations concerning national bank operating subsidiaries appear in 12 C.F.R. § 5.34.

Under the International Banking Act of 1978 (the "IBA"),[78] a foreign bank becomes subject to the BHC Act upon establishment of a branch, agency or commercial lending subsidiary in the United States.[79] In such cases, the IBA provides that the foreign bank is subject to the strictures of the BHC Act "as if" it were in fact a holding company for a U.S. bank (notwithstanding the fact that it has no U.S. bank subsidiary). Of course, a foreign bank that establishes or acquires a U.S. bank subsidiary is also directly subject to the BHC Act by its own terms.

One important consequence of these rules, prior to the Gramm-Leach-Bliley Act, was that a non-U.S. bank with U.S. banking operations could not acquire or merge with a non-U.S. insurance company if, after the acquisition or merger, U.S. banking and insurance operations would be under common control. In some cases, this led foreign institutions to forego their U.S. banking operations in order to acquire and retain a U.S. insurance business. Under the Gramm-Leach-Bliley Act, qualifying foreign banks should no longer face difficult choices of this type. A foreign bank that is subject to the BHC Act by virtue of its U.S. banking operations may elect to qualify as an FHC and thus enjoy the authority in the United States to engage in the broader range of activities that are deemed to be financial in nature, including insurance and merchant banking.

The Gramm-Leach-Bliley Act has a number of provisions that directly address the regulation of foreign banks and their subsidiaries in the United States. In general, these provisions are intended to preserve the IBA's policy of "national treatment" of foreign banks. To this end, the Gramm-Leach-Bliley Act provides that:

- a foreign bank or foreign company with U.S. operations may elect to be treated as an FHC, in which case it can no longer rely on its grandfather rights under the IBA with respect to any

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78 Codified at 12 U.S.C. § 3101 *et seq.*

79 IBA § 8(a), 12 U.S.C. § 3106(a).

of its activities which are permissible for FHCs (*i.e.*, the "financial activities" of its U.S. subsidiaries must conform to the requirements of the Gramm-Leach-Bliley Act);[80]

- whether or not a foreign bank elects to be treated as an FHC, its grandfathered nonfinancial activities, if any, continue to be grandfathered;
- the Federal Reserve Board must apply "comparable" capital and management standards to foreign banks with U.S. operations "giving due regard to the principle of national treatment and equality of competitive opportunity";[81] and
- as with domestic institutions, the Federal Reserve Board is granted broad power to impose restrictions with respect to "relationships or transactions" between a U.S. branch, agency or lending subsidiary of a foreign bank and its U.S. affiliates[82] if the Federal Reserve Board deems such restrictions appropriate to avoid safety and soundness risks or other adverse effects.[83]

These provisions in the Gramm-Leach-Bliley Act are intended to give foreign banks with a U.S. banking presence access to comparable competitive opportunities to engage in financial activities in the U.S. as are now available to domestic bank holding companies. The Dodd-Frank Act preserves this dynamic with respect to foreign banks, but with a caveat. In acting on any application by a foreign bank to establish a branch or an agency, or acquire ownership or control of a commercial

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80 § 141 of the Gramm-Leach-Bliley Act, amending 12 U.S.C. § 3106(c)(3).

81 § 103(a) of the Act; 12 U.S.C. § 1843(l)(3).

82 The term "affiliate," used throughout Gramm-Leach-Bliley but defined only sporadically with respect to certain sections of the Act, adds an element of ambiguity to many provisions. It is unclear here whether the restriction is intended to sweep in "relationships or transactions" among subsidiaries of national banks as "affiliates."

83 § 114(b)(4) of the Act.

lending company, the Board may take into account, for a foreign bank that presents a risk to the stability of the U.S. financial system, whether the home country of a foreign bank has adopted, or is making demonstrable progress toward adopting, an appropriate system of financial regulation for the financial system of such home country to mitigate such risk.[84]

a. Criteria to Become an FHC

A foreign bank that is a bank holding company because it owns a subsidiary bank in the United States is subject to the BHC Act directly (and not by virtue of the IBA) and must therefore satisfy the same criteria as domestic bank holding companies in order to become an FHC. However, most foreign banks present in the U.S. do not operate through bank subsidiaries. Hence, the Gramm-Leach-Bliley Act provides that the Federal Reserve Board shall apply "comparable" capital and management standards to a foreign bank that operates a branch or agency, or owns a commercial lending subsidiary, in the U.S., "giving due regard to the principle of national treatment and equality of competitive opportunity."

The Federal Reserve Board's rule implementing the financial holding company provisions of the Gramm-Leach-Bliley Act sets forth, among other things, the standards that such foreign banks must meet in order to be considered "well capitalized" and "well managed."[85] Section 225.90 of the rule provides two methods under which a foreign bank may be considered well capitalized. The first method is available only to foreign banks from countries that have adopted risk-based capital adequacy rules consistent with the Capital Accord of the Basel Committee on Banking Supervision (the "Basel Accord"). Foreign banks in this category must have a ratio (calculated under home-country

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[84] § 173(a)(3) of the Dodd-Frank Act, amending 12 U.S.C. § 3105(d)(3).

[85] 12 C.F.R. § 225.90-225.92.

standards) of total capital to total risk-based assets of at least 10%, a ratio of Tier 1 capital to total risk-based assets of at least 6%, and possess capital comparable to the capital required for a U.S. bank owned by an FHC.

The rule sets forth a second method for foreign banks to be considered well capitalized. In the case of a foreign bank from a country that has not implemented the Basel Accord or that otherwise does not meet the criteria under the first method discussed above, the foreign bank may petition the Federal Reserve Board for a prior determination that the foreign bank's capital is "otherwise comparable" to the capital that would be required of a U.S. bank owned by an FHC.

The Federal Reserve Board's rule also sets forth the standards for determining whether a foreign bank should be considered well managed. Under Section 225.90 of the rule, the foreign bank must have received at least a satisfactory composite rating of its U.S. branch, agency and commercial lending company operations on its most recent assessment. In addition, the Federal Reserve Board will require that the foreign bank's home country supervisor consents to the foreign bank expanding its activities in the U.S. to include activities permissible for an FHC, and that management of the foreign bank meets standards comparable to those required of a U.S. bank owned by an FHC.

Section 225.92(e) of the rule provides that in determining whether a foreign bank is well capitalized and well managed, the Federal Reserve Board may take into account the foreign bank's composition of capital, Tier 1 capital to total assets leverage ratio, accounting standards, long-term debt ratings, reliance on government support to meet capital standards, the foreign bank's anti-money laundering procedures, the extent to which the foreign bank is subject to comprehensive consolidated supervision or regulation, and other factors that in the Federal Reserve Board's judgment may affect the analysis of capital and management. In making these determinations, the Federal Reserve Board will consult with the foreign bank's home country supervisor as appropriate. It is still unclear to what extent prudential standards implemented under the Dodd-Frank Act, such as the requirement that

financial holding companies be well capitalized and well managed at the holding company level, would apply to the U.S. operations of foreign bank holding companies or their foreign parents. Just as under the Gramm-Leach-Bliley regime, however, it is clear that under the Dodd-Frank Act, U.S. regulators of bank holding companies should consult with a foreign bank's home country supervisor, when appropriate.[86]

b. QFBO Rule

For a U.S. company that is or becomes a bank holding company, the restrictions of the BHC Act and Dodd-Frank Act apply to all of its activities (and those of its subsidiaries) anywhere in the world. In the case of most foreign banks, however, this broad extraterritorial reach is significantly cut back by the rules for "qualifying foreign banking organizations" (commonly referred to as "QFBOs").[87] A QFBO is any foreign bank (and any company of which that foreign bank is a subsidiary) that meets the following two tests: (i) disregarding its U.S. banking (*e.g.*, the activities of the foreign bank's U.S. branch), more than half of its worldwide business is banking; and (ii) more than half of its banking business is outside the United States.[88]

In substance, the QFBO definition embodies the idea that a *bona fide* "bank" (*i.e.*, an entity meeting the first test) which is also a *bona fide* "foreign" bank (*i.e.*, it meets the second test as well) should be free to enter the U.S. banking market subject to the same rules as domestic bank holding companies, while at the same time remaining free to conduct whatever more expansive set of non-U.S. activities are allowed under the laws of its home jurisdiction. A foreign bank that does not satisfy the QFBO tests would, absent special dispensation from the

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[86] § 113(i) of the Dodd-Frank Act.

[87] These rules, premised on BHC Act §§ 2(h) and 4(c)(9), are set forth at 12 C.F.R. § 211.23.

[88] 12 C.F.R. § 211.23(a).

Federal Reserve Board, have to comply with the BHC Act on a global basis.

The QFBO tests are applied to the foreign bank on a *consolidated* basis with respect to the following three criteria: (i) assets, (ii) gross revenues, and (iii) net income from banking activities. In order to be a QFBO, the foreign company must meet the first QFBO test on the basis of at least two out of these three criteria and must meet the second QFBO test also on the basis of at least two (but not necessarily the same two) criteria.

In order to apply these criteria, a critical question is obviously what constitutes "banking" for purposes of the QFBO tests? Prior to enactment of the Gramm-Leach-Bliley Act, this question had a clear answer: any activity on the Regulation K list of permissible offshore activities for U.S. bank holding companies is deemed to be "banking" when conducted by the foreign bank or its subsidiaries.[89] One could argue that, with passage of the Act, any financial activity permitted for FHCs should be treated as "banking" under the QFBO tests.

However, when the Federal Reserve Board approved comprehensive revisions to Regulation K on October 17, 2001, it expressly declined to make any changes to the list of activities that would be considered "banking" for purposes of the QFBO tests, noting that there have been very few cases in which a foreign banking organization failed the test because certain activities were not included on the list. The Federal Reserve Board also noted the existence of its own authority to make special determinations of eligibility for some or all of the QFBO exemptions. For those foreign banks for which ongoing satisfaction of the QFBO tests is a close question, the Gramm-Leach-Bliley Act may

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[89] 12 C.F.R. § 211.10.

provide a reasonable basis on which to petition the Federal Reserve Board for relief under Section 4(c)(9) of the BHC Act.[90]

7. AFFILIATIONS BETWEEN BANKS AND INSURERS

An FHC can own or acquire any kind of insurance company or insurance broker or agent. Under state law, an FHC would need to apply to the insurance commissioner in the insurer's state of domicile for prior approval of the acquisition, and the Gramm-Leach-Bliley Act provides that the commissioner, in considering the application, may not discriminate against the FHC because it is affiliated with a bank or other depository institution.[91]

The Gramm-Leach-Bliley Act provides that no state may prevent or restrict a depository institution or an affiliate thereof from being "affiliated directly or indirectly or associated[92] with any person, as authorized or permitted by this Act or any other provision of Federal law."[93] This is a broad preemption. If the acquiror is a holding company that owns a small bank, then the Gramm-Leach-Bliley Act preempts any state laws or state regulatory actions that prevent any

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90 Petitions for relief on the basis of a foreign bank's particular circumstances are expressly contemplated in Regulation K, 12 C.F.R. § 211.23(g), as are petitions for a specific determination of eligibility for QFBO status by foreign organizations not otherwise qualifying under the standard QFBO rules, 12 C.F.R. § 211.23(e).

91 § 104(c)(1) of the Gramm-Leach-Bliley Act.

92 The only definition of the term "associated" resides in Section 231(a) of the Act (codified at 78 U.S.C. § 78(q)(i)(5)), which pertains to Securities and Exchange Commission supervision of investment bank holding companies. There the term is defined essentially the same as the term "affiliate" in Section 104(g) of the Act. It is unclear what more the term "associated" was intended to add.

93 § 104(c)(1) of the Gramm-Leach-Bliley Act.

affiliation. For example, the quoted sentence would preempt all state insurance holding company acts to the extent they require prior approval of acquisition of control of an insurer (including the parent of an insurer). However, the Gramm-Leach-Bliley Act contains exceptions to this broad preemption. The Gramm-Leach-Bliley Act does not prohibit a state from approving or disapproving any proposed "acquisition of, or a change or continuation of control of, an insurer domiciled in that State."[94] This savings clause preserves the ability of the insurance commissioner of the state of domicile to approve or disapprove the acquisition of control during a specifically designated 60-day period preceding the effective date of the acquisition, so long as it does not have the effect of discriminating, intentionally or unintentionally, against a depository institution or an affiliate or associate thereof. Furthermore, the insurance commissioner of any state where the insurer is engaged in the business of insurance and regulated as an insurer may collect information during the 60-day period.[95] And during the 60-day period the commissioner of the state of domicile may require the acquiror to bring the insurer's capital up to the amount required under the state's risk-based capital requirements of general applicability so that the insurer does not need to file an action plan with the state.[96] The Gramm-Leach-Bliley Act does not explicitly address ongoing compliance with risk-based capital requirements, which may obligate the insurer to take action and may authorize or obligate the regulator to place the insurer in receivership but do not by their terms obligate a parent to make capital infusions.

However, these savings clauses do not explicitly preserve the prior approval statutes that apply to insurers "commercially domiciled" in a state. A total of six states treat as "commercially domiciled" any licensed insurer that writes more than a specified percentage of its

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94 § 104(c)(2)(A)(i) of the Gramm-Leach-Bliley Act.

95 § 104(c)(2)(A)(ii) of the Gramm-Leach-Bliley Act.

96 § 104(c)(2)(B) of the Gramm-Leach-Bliley Act.

insurance in the state constituting more insurance in that state than in its state of domicile.[97] Those states have laws that require the state's prior approval of an acquisition of control of an insurer commercially domiciled in the state. This prior approval requirement may well be preempted where the acquiror is affiliated with a bank.

Furthermore, the Gramm-Leach-Bliley Act preserves the market share statutes in 24 states to the extent they require submission of market share data, but does not explicitly preserve the power of insurance commissioners in market share states to block an acquisition of control (if such power exists) or revoke the license of the target insurer on the ground of excessive market share in the state.[98]

This preemption could result in making it easier for bidders with bank affiliates to succeed in a hostile bid than bidders without a bank subsidiary, because the acquisition by the FHC (or BHC that is acquiring, for example, a financial guaranty company) would need approvals of state insurance commissioners in fewer states. However, this preemption will not completely change the dynamics in hostile situations, because the Gramm-Leach-Bliley Act has no effect on structural defenses that many insurance groups possess, including staggered terms for the board of directors and, most importantly, shareholder rights plans (sometimes called poison pills). Such plans preclude an acquisition without the board's cooperation and thus require a bidder to negotiate with the board (or launch a proxy contest to replace the board).

Sections 104(d)(2)(A) and 104(d)(2)(C)(iii)(I) of the Gramm-Leach-Bliley Act specifically preserve the ruling in *Barnett Bank of Marion County N.A. v. Nelson*,[99] which, as noted above, prohibits state insurance regulators

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97 For a discussion of "commercially domiciled" statutes, see Section 2.b(1) of Chapter Four.

98 For a discussion of "market share" statutes, see Section 2.b(2) of Chapter Four.

99 517 U.S. 25 (1996).

from preventing or significantly interfering with the ability of a depository institution or its affiliates to engage in insurance sales, solicitations or cross marketing activities. Such laws, on the books in a number of states, are preempted. However, the Act creates 13 safe harbors for state insurance laws, including restrictions regarding anti-tying, deceptive advertising, disclosure, payment of commissions and referral fees, sharing of customer information, insurance documentation, aggregation of insurance and banking costs in a single bill and maintenance of separate books and records for insurance activities.[100]

8. FACILITATING AFFILIATIONS WITH MUTUAL INSURERS

Mutual insurance companies have no upstream holding company that can become an FHC. They can affiliate with banks only by buying a bank as a subsidiary of the mutual.

Under the Gramm-Leach-Bliley Act, no state may prevent or interfere with an insurer's investing up to 5% of admitted assets in a bank or BHC.[101] This allows mutual life insurers to acquire or form smaller banks.

The Gramm-Leach-Bliley Act also prohibits a state from preventing or substantially interfering with the demutualization of a mutual insurer (whether into a mutual holding company or otherwise) except the state of domicile.[102] Thus, the state of domicile will continue to regulate a demutualization under its law. This provision of the Gramm-Leach-Bliley Act affects New York's unique law[103] that authorizes its

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[100] § 104(d)(2)(B) of the Gramm-Leach-Bliley Act.

[101] § 306(2) of the Gramm-Leach-Bliley Act.

[102] § 306(3) of the Gramm-Leach-Bliley Act.

[103] New York Ins. L. § 1106(i).

Superintendent of Insurance to review the demutualization of an insurer licensed in New York and domiciled elsewhere and to specify conditions for the continued licensing of the insurer after the demutualization.

Many states' demutualization laws impose temporary restrictions on acquisition of control during the early years after the demutualization. For example, under state insurance holding company acts, which require prior approval of any acquisition of control of a domestic insurer, ownership of 10% of the voting stock is presumed to confer control. These states' demutualization laws require prior approval of the commissioner before anyone may acquire beneficial ownership of 5% of the stock during the first five years after the demutualization. The Gramm-Leach-Bliley Act expressly preserves such laws so long as they do not discriminate against banks or their affiliates.[104]

Finally, under the Gramm-Leach-Bliley Act, no state may prevent or interfere with the redomestication of a mutual to another state to form a mutual holding company.[105] Furthermore, the Gramm-Leach-Bliley Act affirmatively authorizes such a redomestication as a step in the formation of a mutual holding company structure if the plan of reorganization of the insurer meets specified federal standards.[106] Thus, the Gramm-Leach-Bliley Act permits mutual holding company

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[104] § 104(c)(2)(C) of the Gramm-Leach-Bliley Act.

[105] § 313 of the Gramm-Leach-Bliley Act.

[106] The regulator in the transferee domicile must determine that the plan of reorganization provides for (i) approval of the plan by a majority of the board of directors and by a majority of the policyholders who vote after appropriate notice and disclosure, (ii) the policyholders have the same voting rights as they did before the reorganization, (iii) any initial public offering of stock must be conducted in a manner approved by the regulator in the transferee domicile, (iv) during a period of six months after the reorganization, no awards of stock grants or stock options may be made to elected officers or directors, (v) the contractual rights of policyholders are preserved, and (vi) the regulator in the transferee domicile approves the plan as fair and equitable to policyholders. § 312(f) of the Act.

reorganizations for those companies that are domiciled in one of the few remaining states with significant mutuals and no mutual holding company law. The insurer would need the approval of the regulator in its new state but would not need approval of the redomestication or the reorganization from the regulator in its former state of domicile.

9. SUPERVISORY FRAMEWORK; FUNCTIONAL REGULATION

a. Regulation of BHCs, FHCs and Other Depository Institutions

The Gramm-Leach-Bliley Act adopted a regulatory framework under which the Federal Reserve Board is the umbrella regulator of FHCs and BHCs, while the OCC, the OTS and the FDIC retained regulatory authority over the categories of depository institutions they historically had supervised. The Federal Reserve Board was given broad power to impose restrictions with respect to "relationships or transactions" between (i) a depository institution subsidiary of a BHC and any affiliate of such depository institution (other than a subsidiary of such institution), or (ii) a State member bank and its subsidiary, if the Federal Reserve Board deemed such restrictions appropriate to avoid safety and soundness risks or other adverse effects.[107] As discussed below, the Gramm-Leach-Bliley Act also adopted a principle of deference to the functional regulator of functionally regulated subsidiaries of an FHC.

The Dodd-Frank Act retains the general outline of the regulatory framework established by the Gramm-Leach-Bliley Act, but eliminates the requirement for deference by the FRB to the functional regulators. The Dodd-Frank Act thus recasts the Federal Reserve Board as a more powerful umbrella regulator of FHCs and BHCs. Moreover, the Dodd-Frank Act also creates a statutory framework focused on systemic risk

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107 § 114(b)(1) of the Gramm-Leach-Bliley Act.

regulation, so-called macro-prudential regulation, in addition to traditional micro-prudential regulation. Unlike micro-prudential regulation, which focuses on the risk to the safety and soundness of an individual institution, macro-prudential regulation focuses on the risk to the financial system as a whole.

b. Regulation of Functionally Regulated Nonbank Subsidiaries

The Gramm-Leach-Bliley Act adopted the concept of deference to the functional regulators of functionally regulated subsidiaries of an FHC. Thus, the supervision of functionally regulated nonbank subsidiaries (such as insurance companies and broker-dealers) was generally reserved for the state and federal regulatory authorities that are otherwise empowered to regulate and oversee the activities of such entities. The Federal Reserve Board had limited authority to supervise and examine such subsidiaries (*e.g.*, in cases where the Federal Reserve Board has "reasonable cause to believe that such subsidiary is engaged in activities that pose a material risk to an affiliated depository institution").[108] In addition, under Section 304 of the Gramm-Leach-Bliley Act, disputes that arose between a federal regulator and a state insurance regulator could be referred to a federal appeals court for expedited review, but gone were the days of judicial deference to federal banking regulators: clause (e) of Section 304 placed federal banking regulators and state insurance regulators on equal footing.

The Dodd-Frank Act enhances the Federal Reserve Board's powers over the nonbank subsidiaries of BHCs and FHCs. The Dodd-Frank Act repeals § 10A of the BHC Act, which limited the Board's authority over functionally regulated subsidiaries of bank holding companies.[109] In addition, the Dodd-Frank Act grants the Board broader authority to

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[108] § 111 of the Gramm-Leach-Bliley Act; 12 U.S.C. § 1844(c)(2)(B)(i).

[109] § 604(c)(2) of the Dodd-Frank Act, amending 12 U.S.C. § 1848(a).

require reports from and examine functionally regulated subsidiaries of BHCs and thrift holding companies.[110] The full effect of these changes, which became effective on July 21, 2011, will only become clear as the Federal Reserve Board's practices in this area evolve.

c. The Federal Insurance Office

The Dodd-Frank Act created the Federal Insurance Office ("FIO") in the Department of the Treasury as the only dedicated repository in the Federal government of knowledge, information, and expertise about the business of insurance. FIO's authorities extend to all aspects of the business of insurance, except health insurance, certain long-term care insurance, and crop insurance.

Dodd-Frank authorizes FIO to (1) monitor the insurance industry, including identifying any issues or gaps in insurance regulation that could contribute to a systemic crisis in the insurance industry or in the U.S. financial system; (2) monitor access to insurance products for low- and moderate-income and other traditionally underserved communities; (3) recommend to the Council that it designate an insurer for heightened supervision by the Federal Reserve Board under Title I of the Dodd-Frank Act; (4) assist the Secretary of the Treasury in administering the Terrorism Risk Insurance Act; (5) coordinate federal policy on prudential aspects of international insurance matters, including representing the United States in the International Association of Insurance Supervisors ("IAIS"), and assist in negotiating international insurance agreements on prudential measures;[111] (6) consult with the states on insurance matters of national and international importance; and (7) perform other duties as directed by the Secretary. In addition,

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110 §§ 604(a), 604(b) of the Dodd-Frank Act, amending 12 U.S.C. §§ 1844(c)(1), 1844(c)(2).

111 § 502(a)of the Dodd-Frank Act, 31 U.S.C. § 313(c)(1).

Dodd-Frank directs that the FIO Director serves as a non-voting member of the Council.

While Dodd-Frank retains the states as the primary functional regulators of the business of insurance, the Act gives FIO limited authority to preempt state law.[112] If the United States enters into an international agreement relating to the prudential supervision of the business of insurance, FIO may preempt any state law that is inconsistent with the international agreement and results in less favorable treatment of a non-US insurer domiciled in a foreign jurisdiction than a U.S. insurer domiciled or licensed in that state.

FIO is authorized to collect data and other information from insurers and insurance affiliates (except small insurers) in order to carry out its authorities.[113] However, before requiring an insurer to produce information, FIO must ascertain that the information is not otherwise available. FIO may compel by subpoena only data that is not available from a public source or from the relevant insurance regulator.[114] Any data request from FIO must comply with the Paperwork Reduction Act.[115] Certain confidentiality rights extend to information shared with the FIO,[116] although FIO's ability to protect collected data from public disclosure has not been definitively established.

According to Dodd-Frank, the FIO Director must submit an annual report on or before September 30 of each calendar year (beginning in 2011) on the insurance industry to the President and to certain Congressional committees.[117] In 2011, that report was not produced.

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112 § 502(a)of the Dodd-Frank Act, 31 U.S.C. § 313(f).

113 § 502(a)of the Dodd-Frank Act, 31 U.S.C. § 313(e).

114 § 502(a) of the Dodd-Frank Act, 31 U.S.C. § 313(e)(6).

115 § 502(a)of the Dodd-Frank Act, 31 U.S.C. § 313(e)(4).

116 § 502(a) of the Dodd-Frank Act, 31 U.S.C. § 313(e)(5).

117 § 502(a) of the Dodd-Frank Act, 31 U.S.C. § 313(n)(2).

The Act also requires the FIO Director to submit to Congress (1) an annual report of its state preemption activity;[118] (2) a report on the regulation of insurance in the United States (which was due on January 21, 2012);[119] and (3) two reports on reinsurance, one due on September 20, 2012; the other on January 1, 2013.[120] As of this writing, the FIO has not produced any of these reports.

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118 § 502(a) of the Dodd-Frank Act, 31 U.S.C. § 313(n)(1).

119 § 502(a) of the Dodd-Frank Act, 31 U.S.C. § 313(p).

120 § 502(a) of the Dodd-Frank Act, 31 U.S.C. § 313(o).

CHAPTER EIGHT — INVESTMENT MANAGEMENT M&A

KENNETH J. BERMAN, GREGORY V. GOODING, WILLIAM D. REGNER AND SETH L. ROSEN[1]

This Chapter outlines the issues involved in buying or selling a U.S. or U.K. investment adviser (an "Adviser") that has a mixed business, including both institutional accounts and funds. The acquisition of an Adviser requires an understanding not only of traditional M&A issues, but also of the unique nature of the advisory business. This includes the fundamental facts that an Adviser's earnings depend less on capital assets than on individual revenue-producing professionals and that an Adviser's primary assets are advisory contracts that may be terminated by the other party on short notice. Furthermore, it is essential to have knowledge of the regulatory framework imposed on U.S. investment advisers and investment companies under the federal Investment Advisers Act of 1940 (the "Investment Advisers Act") and Investment Company Act of 1940 (the "Investment Company Act"), and the regulatory framework imposed on U.K. investment advisers by the Financial Services Authority ("FSA") and the Financial Services and Markets Act 2000 ("FSMA"). The regulatory framework in the United States has changed in certain significant respects as a result of the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

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1. DEAL STRUCTURING

a. Retaining Key Employees

The advisory business, wherever it is conducted, is a people business, not a capital equipment business. A key to a successful acquisition of an investment adviser is retaining and motivating key personnel — senior management, portfolio managers and marketers.

The first step is to identify the key employees and their degree of importance to the enterprise. There may be several tiers from the perspective of a buyer ("Acquiror"): a core group of employees without whom Acquiror would not be willing to close; a larger group that Acquiror regards as important to the continuing success of the enterprise and would like to retain for the long term; and, perhaps, a third group that may be important to the successful transition of the acquired business, but is not significant to its long-term success. What compensation terms will apply to each group and when and how will they be finalized?

For Acquiror, it is important to determine the parameters of pre-closing retention and post-closing compensation as part of, and not separate from, purchase price negotiations. The negotiating dynamics and deal structure will be different depending on whether the owner of the Adviser (the "Seller") is a group of employee owners, or a parent company seeking to exit the advisory business. Post-closing compensation discussions will happen naturally — and relatively early — when the Seller is a management group, because no selling principal will want to commit to a sale of his or her ownership interest without knowing the post-closing compensation structure. A selling parent company, on the other hand, will be more focused on the up-front purchase price, leaving it to Acquiror to worry about retaining the employees on the back end, although the selling parent may enter into stay-pay, success bonuses or other incentive arrangements to retain personnel until the closing.

Where possible, it is desirable for Acquiror to enter into employment agreements with essential employees at the time of signing the acquisition agreement and to require continued employment under the terms of these agreements as a condition to closing. This will require agreement on all compensation terms by the time of signing. Leaving these terms to be worked out between signing and closing can substantially shift leverage to the essential employees.

With respect to key employees outside the core group of truly essential individuals, it may not be possible or desirable to finalize all compensation terms prior to signing. In this case, Acquiror may consider requiring a closing condition based on continued employment of some critical mass, but not tied to specific individuals: for example, at least six out of ten specified employees. This protects Acquiror while mitigating somewhat the leverage of any one employee in this second group. For an Acquiror seeking to consolidate operations, the resignation of key Adviser employees may be required. In this case, severance costs often will be borne by the Seller.

The issue of longer-term retention by Acquiror is a key element of any investment management M&A transaction. Retention and motivation tools are traditionally divided between "carrots," compensation packages structured to maintain and reward effort and success over an extended period, and "sticks," non-competition or "garden leave" provisions that both limit the key employees' options and protect the acquired business.

The carrots include:

- **Earn-Out**. Part of the purchase price may be made payable on a deferred basis, contingent on the Adviser's meeting certain growth, revenue or earnings targets. Earn-out payments may be used as carrots for key employees where the Seller is a management group. Management Sellers will have an incentive to use their efforts to see that the Adviser can meet the earn-out targets. Management Sellers will often seek some degree of post-closing control over the Adviser's business to "protect" their earn-out. Earn-outs can raise significant issues for both

Acquiror and the Seller. They can give rise to disputes as to whether the applicable targets were met – or failed to be met as a result of improper actions taken by Acquiror during the earn-out period. Earn-out arrangements may have substantial accounting implications, as payments contingent on continued employment may reduce earnings. In addition, amounts received by a management employee under an earn-out arrangement, if tied to that employee's continued employment during the earn-out period, will likely be taxed to the employee as ordinary compensation income (subject to both income and employment taxes).

- **Equity Stake**. Key personnel can be offered an equity stake in the ongoing business. The stake can be structured as an acquisition of less than 100% of the equity of the Adviser, as options or restricted stock awards, or as a purchase by management of equity at the closing (possibly with additional rights to increased ownership vesting over time). Equity incentive programs may also take the form of equity available for purchase from the majority owner at prices fixed as of certain dates. An well – structured equity program can make it less likely that personnel will walk away and work for competitors. Important structuring consideration include the size of the program (i.e., the amount of each person's equity stake and the extent to which the equity does or doesn't replace compensation previously paid in cash); what the equity represents (e.g., a right to current distributions of income, exit proceeds or both, or distributions only an excess of a hurdle); and whether and how personnel will eventually become liquid in their equity. If the company is private, personnel often will seek put rights or other assurances of liquidity for their equity. To induce personnel to stay after the closing, Acquiror may provide that puts or other liquidity rights cannot be exercised for some period following the transaction (for example, two or more years), or that repurchases will be made at a significant discount if an officer or employee leaves early. Also, the pay-

out of equity can be staggered over a period of years following termination of employment in order further to discourage potentially departing personnel. Key personnel who are also equity owners prior to the transaction may wish to explore a structure in which they can roll over their existing interests on a tax-free basis, rather than selling their existing interests in a taxable transaction and reinvesting the after-tax proceeds. Such arrangements may be difficult or impossible to structure if equity is expected to vest over time. Acquirors that are public companies may have readily available equity securities that can be used as incentive compensation, but the success of the acquired Adviser may not correlate directly with Acquiror's stock price. Granting or allowing the retention of equity in a subsidiary Adviser can raise difficult issues as to the treatment of minority shareholders and can affect tax consolidation.

- **Other Incentive Compensation**. Compensation may be tied to investment performance or to the success of the business, in whole or in part based on the performance of a specific group or fund. For example, the annual bonus arrangements are often pre-negotiated, from the size of the aggregate pool to the individual allocations (or, at least, the methodology by which individual allocations will be determined).
- **Perquisites**. Agreeing to perquisites may be useful, depending on functions performed and individual needs and personalities.
- **Culture**. It is often a vital concern of the Adviser's professionals that their firm culture – which usually equates to professional autonomy – not be threatened. This issue is generally addressed by the parties' getting comfortable with each other, but more concrete arrangements can be supported by governance provisions and contractual covenants. These issues may be addressed differently by the strategic buyer and by the financial buyer.

The sticks include:

- **Non-Compete or "Garden Leave" Agreements**. In the U.S., the enforceability of non-compete agreements varies from state to state, and will depend on their duration, geographic coverage and professional scope. A distinction is generally made between restrictions agreed to by the owner of a business as part of a sale of that business and restrictions agreed to by an employee solely in connection with employment. A seller's non-compete is more likely to be upheld and for a longer term than will an employee's non-compete. In California and other states, employee non-competes are either difficult to enforce or, in some cases, simply unenforceable.

- **Non-Solicitation Agreements**. Restrictions on solicitation of other employees or clients upon leaving the Adviser can be an important protection for the Acquiror and do not raise to the same extent the enforceability issues referred to above.

- **Performance Data**. Employees may be required to agree to restrictions on the use of performance data or "track record" upon leaving the Adviser. This can be a particularly sensitive issue in the case of private equity or hedge fund personnel.

- **Staggered-Term Employment Agreements**. Employees can be signed to employment agreements having staggered terms. Coupled with non-competition provisions, staggered-term agreements may make it more difficult for a group of employees to leave together to join a competitor.

- **Termination**. Employment agreements may provide for the termination of the officer or employee for "cause," as defined in the agreement, or without cause. It may be desirable to apply different non-competition or non-solicitation provisions depending on the manner of termination. Additional protections for the employer include forfeiture of bonus, earn-out and other rights upon termination for cause (or in the event the employee leaves without good reason).

- **Closing Condition; "Stay" or Retention Bonuses**. Employment or non-compete/garden leave agreements with key persons should be negotiated in advance and become effective at the closing. At an early stage of the transaction, Acquiror should determine whether there are any employment agreements currently in force that would keep key persons in place through the closing of the transaction. A post-closing "stay" bonus could be offered to key persons who stay through the pending transaction. The bonus should be meaningful relative to existing compensation and options. The longer the length of service required post-closing, the larger the bonus payment will need to be in order to be considered meaningful.

b. Client Retention

A transaction in which Acquiror acquires control of the Adviser will constitute an "assignment" to Acquiror of the Adviser's U.S. investment advisory agreements under the Investment Company Act and the Investment Advisers Act, even if the advisory agreements are silent on this point. This is the case whether the transaction is structured as an asset sale (requiring a direct transfer of the advisory agreements) or as an acquisition of ownership of the Adviser itself. Similarly, the Investment Advisers Act requires that an investment advisory agreement provide that it cannot be assigned without the consent of the client. The Investment Company Act provides that an advisory agreement with a registered investment company will terminate automatically on assignment. Accordingly, Acquiror will have to consider carefully the amount (measured in terms of run rate revenues or assets under management) of client consents Acquiror will require as a condition to closing, what effect, if any, the failure to receive client consents could have on the purchase price, and the procedure, timing and cost considerations for obtaining client consents. Further discussion of the regulatory requirements relating to client consents is included in Section 2 below.

c. Form of Transaction

The form of transaction depends on business terms, as well as securities and tax law requirements.

(1) Asset Purchase

In an asset purchase, the Seller transfers assets — such as advisory contracts and employment agreements, leases, books and records, intellectual property rights, proprietary systems and the associated goodwill — to Acquiror or a subsidiary of Acquiror. This form of transaction may avoid assumption of the Adviser's unwanted liabilities and is particularly useful if only part of a business is being acquired; however, the documentation can be more complex. In addition, an asset purchase can provide tax benefits to the Acquiror, because the Acquiror will usually "step up" the tax basis of the acquired assets for tax purposes (including its basis in goodwill), and, at least in the U.S., can amortize the basis over a period of up to 15 years (longer in the case of real estate). However, special "anti-churning" rules limiting the value of the step-up may apply if the Sellers will have a continuing equity interest in the Adviser. Some portion of the purchase proceeds may be taxable to the Seller as ordinary income rather than capital gain. Moreover, if the Adviser is organized as a "subchapter C" corporation, an asset sale will likely result in double taxation of the sale proceeds, and some double taxation may result even if the Advise is structured as a "subchapter S" corporation.

(2) Stock Purchase

Advantages of a stock purchase include reducing the need for non-client third-party consents, ensuring the transfer of all assets needed to run the business and, from the Seller's perspective, enabling all liabilities to transfer with the acquired Adviser. If the Adviser is a partnership (or a limited liability company that elects to be taxed as a partnership), a stock

purchase can result in a step-up in the basis of the underlying assets for tax purposes, and also the possibility of ordinary income treatment for part of the proceeds (in essentially the same manner as an asset purchase) without the potential for double taxation of the proceeds. If the Adviser is taxable as a corporation, the tax advantages of a basis step-up can generally only be achieved in a stock sale if the Adviser is a corporate subsidiary or a "Subchapter S" corporation, and the Acquiror and Seller elect (under Section 338(h)(10) of the Internal Revenue Code) to treat the stock sale as an asset sale for federal income tax purposes. Even in the case of a Subchapter S corporation, however, a Section 338(h)(10) election (or a true asset sale) can have unexpected tax costs to the Seller if the Adviser converted to a Subchapter S corporation less than 10 years prior to the acquisition.

(3) Joint Venture or Majority Investment

Acquisition of a controlling (but less than 100%) interest in the Adviser provides the benefits of ownership control of an Adviser, while providing significant ownership incentives for existing management to remain and perform (assuming members of management are joint venture partners). This can be done whether the Adviser is a partnership, a corporation or a limited liability company. The tax consequences of a joint venture arrangement will vary greatly depending upon the facts and structure of each particular transaction. Cross-border joint ventures can involve complex tax planning as well as regulatory issues that will need to be identified in the early stages in order to anticipate timing concerns.

An Acquiror entering into a joint venture or majority investment will often require a right of first refusal in the event that a transfer of the minority interest in the Adviser is contemplated. Acquirors also typically seek "drag-along" rights ensuring their ability to cause the sale of the entire business in the future (and Sellers seek "tag-along" rights ensuring that they will not be left behind if Acquiror later sells a controlling interest in the Adviser). Acquirors may also seek the ability

to obtain 100% ownership over time, through call rights. Where minority interests are originally held not only by the Seller but also by persons not participating in the sale to Acquiror, it may be necessary to induce such persons to enter into a separate agreement with Acquiror in order for Acquiror to acquire the desired rights.

Joint ventures and majority investments require up-front consideration of exit events and strategies, as well as pricing, in order to minimize disputes if the venture proves unsuccessful or outlives its utility to one or both of the parties.

(4) Merger

In a merger of Acquiror (or a subsidiary of Acquiror) and the Adviser, one corporation is absorbed into a surviving corporation, which acquires all of the absorbed corporation's assets, rights, liabilities and obligations. If the surviving corporation is newly organized, it will be important to assure that any licenses or other contractual and legal rights held by the merged company can either be acquired by succession or otherwise used. The tax consequences of merger will depend upon a number of variables, including the precise structure of the transaction and the form of consideration (cash versus stock) paid. If the acquisition is structured as a merger in which at least 50% of the consideration is stock, the stockholders of the Seller can usually defer gain on the sale as to the stock received.

(5) Hostile Acquisitions

Hostile acquisitions of investment advisers are very rare. Many investment advisers are privately held. Even for publicly held Advisers, potential hostile deals are deterred by the fact that the managers of the business are free (subject to non-competition or garden leave clauses) to leave the Adviser if they are unhappy, the advisory contracts with registered investment companies all terminate if control of the Adviser changes without client consent, and the advisory contracts with other

clients prohibit assignment (including as a result of a change of control) without consent.

d. The Acquisition Agreement

(1) Purchase Price

The purchase price is often determined in relation to the Adviser's revenues or profits. Other formulas provide for a purchase price based on a stated multiple of the Adviser's assets under management or gross advisory fees.

Accordingly, a key concern is the continuation, post-transaction, of the Adviser's advisory relationships and retention of its revenue-generating assets under management. The purchase price is often adjusted based on changes in the amount or type of assets under management. The mechanism for this adjustment may include some or all of the following:

- The adjustment formula may be based on the amount of assets under management as of the closing or a specified date before or after the closing, compared to assets under management at an earlier "base date" on the basis of which Acquiror priced the transaction. This formula may be structured to prevent changes in market value of assets under management from affecting the purchase price.
- Part of the payment can be made at a delayed second closing, once it is known how many of the required consents and approvals were in fact obtained. This mechanism is often used for mutual fund shareholder consents.
- The Seller may seek corresponding upward adjustments in the event of material positive changes, such as new assets obtained or revenue targets achieved within a specified time period following the closing.

- The Adviser may identify key prospects expected to enter into advisory contracts due to the Adviser's pre-closing sales efforts. The Seller may seek a positive purchase price adjustment for any such prospect that does so. Conversely, the Acquiror may designate key clients or funds whose failure to consent to the continuation of an advisory contract would trigger a downward purchase price adjustment.

- The purchase price may be paid in installments, or there may be a contingent purchase price tied to the Adviser's future financial performance. Installment payments also may be linked to the amount of assets under management, revenues or profits on each payment date.

- Where the Adviser owns hard-to-value assets, such as carried interests in private funds, earn-outs may be used to bridge the valuation gap.

- In connection with the calculation of the purchase price, Acquiror may require that an estimated closing balance sheet for the Adviser be delivered prior to the closing. Appropriate adjustments to the purchase price and/or any earn-out formula can be made when the estimated balance sheet is reconciled against an audited balance sheet as of the closing date.

As part of the consideration, Acquiror may agree to assume responsibility for debt of the Adviser. Depending on the terms of the underlying debt instruments, the consent of the debt holders to the transaction may be required.

Depending on the Adviser's cash flows and business needs, the Adviser may seek commitments of working capital from Acquiror. When this is the case, the key issues typically include:

- Will the working capital take the form of a loan, a line of credit, a capital contribution or some combination? How will the availability of working capital affect the purchase price? Will interest and principal repayments be required and, if so, when?

- On what terms will working capital be made available? Working capital can be made freely available (subject to maximum amounts) upon the request of the Adviser, or can be provided only for uses specifically identified by the Adviser and subject to review and approval by Acquiror.

In other cases, Acquiror may seek commitments from the Seller to maintain "seed capital" in existing investment products of the Adviser, and perhaps also to commit seed capital for future products.

A portion of the purchase price may be allocated to a non-compete agreement covering the entire industry or specific market segments. This allocation may have important tax implications. If capital gains are taxed at rates lower than ordinary income rates (if the Sellers are individuals), Acquiror and the Sellers will seek different allocations of the purchase price to the non-compete. The portion so allocated may be amortizable by Acquiror but will be ordinary income to the Sellers; if the Adviser is a corporation, the portion allocated to the Adviser's stock will be treated as capital gains to the Seller and taxed at that lower rate. If the Adviser is structured as a partnership, some part of the purchase price may be ordinary income, but much of the proceeds will be taxable at capital gain rates. An allocation of purchase price to a covenant not to compete will increase the ordinary component.

(2) Representations and Warranties

In addition to the standard corporate representations and warranties, in the U.S. the Seller usually provides detailed representations as to regulatory compliance and other matters. The level of detail may depend upon the nature of the transaction and whether the advisory contracts relate to a fund organized by the Adviser ("sponsored funds") or are subadvisory agreements with funds organized by others. The Acquiror should also be sensitive to the significant changes in the regulation of investment advisers and other financial institutions in the United States. For example, as discussed in Section 2(f), private fund sponsors will be subject to heightened regulatory scrutiny as a result of

the Dodd-Frank Act. In addition, the SEC has adopted rules that place additional burdens on investment advisers (such as the Advisers Act custody rule and the "pay to play" rule discussed below). Examples of common representations include:

- All correspondence with regulators, pending or anticipated regulatory investigations or audits, consent decrees and agreements with regulators have been disclosed.
- The Adviser and the funds that it manages have filed all required regulatory reports and such filings were true and correct and complied in all material respects with applicable law.
- The Adviser and the funds have been operated in compliance in all material respects with applicable law.
- The Adviser, if it is required to be, has been duly registered under the Investment Advisers Act and under state law; the U.S. investment companies advised by the Adviser, if they are required to be registered, have all been duly registered under the Investment Company Act, and their shares are duly registered for sale under the Securities Act of 1933 (the "Securities Act").
- Any non-U.S. investment companies advised by the Adviser have complied with applicable non-U.S. laws, are exempt from registration under the Investment Company Act, and are not required to have their shares be registered under the Securities Act or state blue sky laws.
- None of the Adviser or the directors, officers or employees of the Adviser (or any investment company advised by the Adviser) is disqualified from acting as such under the Investment Advisers Act, the Investment Company Act or other applicable law because they have been convicted of certain crimes or are subject to other specified disqualifications.
- The Adviser and the U.S. investment companies advised by the Adviser have been in compliance with the Investment Advisers Act and the Investment Company Act, and any affiliated

broker-dealer has been in compliance with the Securities Exchange Act of 1934 (the "Exchange Act") and applicable FINRA rules.

- The Adviser (if publicly traded) and any publicly traded funds or mutual funds advised by the Adviser have been in compliance with the Sarbanes-Oxley Act of 2002 (including representations as to the adequacy of internal controls relating to financial statements and disclosures).

- The Adviser has paid all of its taxes and otherwise complied with tax laws; the Adviser's clients that are registered as investment companies under the Investment Company Act ("registered funds") have maintained the tax status of qualified regulated investment companies and other investment vehicles advised by the Adviser qualify for favorable tax treatment (for example, flow-through taxation) that was promised to investors; all income tax reporting and withholding obligations have been complied with.

- The Seller has disclosed to Acquiror all material contracts to which the Adviser is a party, including investment management agreements.

- The Adviser and the registered funds advised by the Adviser have adopted various policies and procedures, including a code of ethics, required under the Investment Advisers Act and the Investment Company Act, and such policies and procedures: (i) are designed to assure compliance with the federal securities laws; (ii) address proxy voting issues and related conflicts of interest; (iii) address the protection of non-public information; (iv) address controls on market timing transactions; (v) address personal trading of employees; and (vi) address privacy of clients, customers and other persons. In addition, there have been no material violations or allegations of violations of any such policies or procedures.

- The Adviser has complied with the provisions of Regulation S-P, the privacy rules promulgated by the SEC under Section 504 of the Gramm-Leach-Bliley Act.
- The Adviser has complied with the applicable anti-money laundering regulations, the Foreign Corrupt Practices Act (anti-bribery and corruption) and Office of Foreign Assets Control regulations (anti-terrorism) with respect to its clients and customers.

In addition to the usual Acquiror representations, the Seller may request additional representations and warranties from Acquiror. One of the more significant representations would confirm that the Acquiror has no plans or proposals that could constitute an "unfair burden" on registered funds under Section 15(f) of the Investment Company Act, discussed below. The acquisition agreement should contain a covenant as to Acquiror's compliance with Section 15(f); this may extend to a specific covenant not to increase fees charged to mutual funds, including distribution fees paid under Rule 12b-1, for two years after the closing.

Where either Acquiror or the Seller has operations outside the United States, each will provide representations and warranties in relation to matters equivalent to those set out above in respect to each of the relevant jurisdictions, including as to compliance with local financial services regulatory laws, securities laws and, as applicable, banking laws, and as to the good standing of each regulated overseas entity with the relevant regulator.

A change of control of any regulated overseas entity in the group of Acquiror or the Seller as a result of the transaction will often trigger a requirement to obtain the prior approval from the regulator of such regulated entity, which will usually be a condition precedent to the completion of the transaction. Often this will mean coordinating the approval process in a number of different jurisdictions within the transaction timetable.

(3) Covenants

The Seller and Acquiror often agree to covenants along the following lines:

- The Seller and the Adviser will conduct the Adviser's business in the ordinary course from the date of the acquisition agreement through the closing date.
- The Seller and the Adviser may not enter into specified material transactions, such as incurring debt outside the ordinary course of business, transferring advisory contracts, or making guarantees or loans.
- Acquiror is given access to the Adviser in order to conduct due diligence, subject to confidentiality agreements.
- Seller will not solicit or initiate discussion with other parties regarding an acquisition.
- Each party agrees to take all reasonable steps to obtain all necessary third-party consents and approvals, including regulatory approvals and consents under advisory agreements (including fund shareholder consents, if necessary), intellectual property licenses, real estate leases and other contracts.
- If desired, specified directors or officers of the Adviser will resign.
- The Seller and Acquiror will use their respective efforts to ensure compliance with Section 15(f) of the Investment Company Act.

(4) Indemnification

The Seller will typically agree to hold Acquiror harmless from damages or liabilities arising from breaches of representations, warranties and covenants. The indemnity may be subject to any of (i) a "basket" (either

a deductible amount below which no indemnity is paid, or a minimum dollar amount in losses that must be reached before losses are indemnified); (ii) a cap on total indemnities (which may be expressed as a percentage of the total purchase price); (iii) a "de minimis" claim exception (a dollar amount below which claims do not count toward the basket or cap); (iv) exclusions of specified liabilities from the indemnity or from the basket or cap; or (v) a specified time limit on indemnity claims following the closing. Where there are multiple owners or individuals in a selling group, the degree to which the indemnification liability will be joint and several is often a topic of negotiation. Acquirors often seek to put part of the purchase price into escrow, or the right to offset indemnification payments against future earn-out or other payments, to support the Seller's indemnification obligations. Also, Acquiror may wish to require multiple Sellers to designate a "Seller's Representative" with whom it can deal exclusively on matters that may result in indemnification claims.

(5) Termination

The acquisition agreement typically provides that it will terminate upon the mutual agreement of the parties or by either party upon the occurrence of specified events, such as the failure to satisfy closing conditions before a specified date. The parties may wish to provide for an agreed-upon allocation of expenses in the event of termination, and for coordination of public statements so that confidential information remains secure and adverse publicity is avoided.

e. Other Transaction Agreements

In addition to the acquisition agreement, it may be helpful or necessary for Acquiror, the Adviser or the Seller to enter into additional agreements relating to the transaction. These agreements often include:

(1) Letter of Intent/Term Sheet

Prior to entering into a formal acquisition agreement, the parties may desire to reflect their understanding in a letter of intent containing the basic terms of the transaction. The letter may include the following:

- Whether a stock purchase, asset acquisition or merger is contemplated.
- A price range or a formula to be applied in arriving at a price.
- Closing condition and purchase price adjustment provisions related to client consents.
- Acquiror's requirement that, as a condition to closing, key personnel of the Adviser enter into employment and non-competition agreements. In addition, the letter of intent may set out the basic parameters of the compensation arrangements for key personnel (including incentives and/or equity interests). If a portion of the purchase price will be allocated to a non-competition agreement, it would be preferable from a tax perspective for that fact to be specified in the term sheet, even if the precise amount has not been agreed.
- An agreement by Seller not to solicit bids from or engage in negotiations with any other person for a specified period.
- An allocation among the parties of responsibility for transaction-related expenses. Costs of seeking client consents can be significant, and their allocation is sometimes a topic of negotiation.

The letter should clearly state which provisions are intended to be binding on the parties (*e.g.*, confidentiality), and which provisions are non-binding. The enforceability of letters of intent varies from jurisdiction to jurisdiction. Acquiror will usually want to make clear that the terms and conditions of any transaction will be contained in a definitive agreement and that the letter is non-binding in this respect. However, the letter will often have at least moral force in negotiations

regarding topics specifically addressed in the letter. The parties must be careful that their course of conduct does not belie the non-binding intent of the letter.

(2) Confidentiality Agreement

Before making preliminary disclosures to the potential Acquiror for purposes of negotiating the acquisition agreement, the Seller typically requires that the proposed purchaser enter into a confidentiality agreement limiting the uses to which the information provided can be put. These agreements often contain reciprocal confidentiality undertakings and, if public companies are involved, standstill provisions. They also often contain restrictions on the ability of the parties to solicit or hire each other's employees.

f. Financing the Acquisition

(1) Theory of Financing

It must always be borne in mind that the advisory business largely depends on people, not on hard assets, and that the principal revenues come from advisory agreements that either (i) for registered funds, will terminate automatically upon the closing of the transaction, requiring a new agreement approved by the directors and, ultimately, the shareholders of the funds, or (ii) for other clients, may not be assigned without the consent of the client.

(2) Security

A pledge of the Adviser's stock to secure financing for an acquisition generally should not be considered an "assignment" of the Adviser's advisory contracts, provided that any foreclosure of the pledge is treated

as an "assignment" subject to the requirements of the Investment Company Act and the Investment Advisers Act.

Granting a security interest in an Adviser's accounts receivable, including Rule 12b-1 fees, generally should not constitute an assignment of the Adviser's underwriting or distribution contracts, provided that any action regarding foreclosure of the security interests is treated as an assignment.[2]

Because of the inability to foreclose on the collateral without approval of the Adviser's clients, pledges of the Adviser's stock or accounts receivable may in some ways be considered to be similar to a no-pledge covenant by the borrower.

(3) Financing Commitments

If Acquiror or an affiliate will raise all or part of the purchase price through an offering of equity or debt securities, the Seller may seek written assurances from Acquiror or its funding sources that Acquiror will have sufficient financing available to close the transaction.

g. International Issues: The U.K.

As stated above, where either Acquiror or the Seller has operations outside the U.S., additional regulatory issues need to be addressed.

To take a common example, where the Seller has a U.K. subsidiary which is regulated by the FSA, both Acquiror and the Seller will need to obtain the prior approval of the transaction by the FSA.

The acquisition of a firm authorized by the FSA will trigger the change of control provisions in the FSMA. Where Acquiror acquires at least 10% of the shares of, or 10% of the voting power in, or is able to

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2 *See Funds, Inc.* (pub. avail. Aug. 12, 1976).

exercise significant influence over the management of, an authorized firm or in one of its "parent undertakings," it becomes the "controller" of such authorized firm and the change of control provisions of the FSMA will apply.

For the purposes of calculating whether the 10% threshold is reached, any shares or voting power acquired by a party acting in concert with Acquiror (i.e., in accordance with an explicit or implicit agreement) need to be included.

The definition of "controller" includes not only the company making the acquisition, but also entities that hold at least 10% of the shares in a parent undertaking of the authorized firm. The definition of "parent undertaking" includes all parents of the firm up to its ultimate parent. Therefore, the FSA will need to approve all intermediate, as well as the ultimate, controllers.

The FSMA requires a person to notify the FSA in writing if it decides to acquire control over an authorized firm. The requirement to notify the FSA therefore arises at an early stage in the acquisition process. If a person proposes to acquire control of an authorized firm, it must obtain the FSA's approval before doing so. A person who fails to notify the FSA of a proposed acquisition of control of an authorized firm, or who makes an acquisition before receiving the FSA's approval, is guilty of an offense.

A notification given to the FSA by a person who is acquiring control over an authorized firm normally comprises information required by the FSA in its standard forms. The FSA requires details to be provided about the nature of the proposed acquisition, including details of the percentage holdings in the authorized firm, before and after the change of control. Corporate structure charts should also be provided, showing the position both before and after the acquisition.

If a controller proposes any significant changes to the firm – for instance, to its regulated activities, business plan or strategy – it will be requested to provide details. The FSA also requires details of whether the controller intends any restructuring, either in terms of the legal form

of the authorized firm being acquired or in its borrowings, capital structure or financial arrangements. Details should be provided of how the transaction is to be financed, including information about the source of funds. The controller should also note any interests that may conflict with its role as a controller of the authorized firm and any other information of which the FSA would reasonably expect notice. Less information is required if the firm acquiring control is itself authorized by the FSA or has a subsidiary that is authorized by the FSA. In addition to information on the controller, where the controller is a body corporate or a partnership, a complete curriculum vitae is required in respect of all members of the governing board, and financial statements for the controller's last three financial periods need to be provided.

The FSA's statutory time limit for considering applications is 60 working days beginning with the day on which the FSA acknowledges receipt of the notice of control from the proposed controller. The assessment period may be interrupted, no more than once, by the FSA's asking the proposed controller in writing to provide any further information necessary to complete its assessment. The FSA may make further requests for information (but a further request does not result in a further interruption of the assessment period). In practice, the FSA tries to deal with applications more quickly than the statutory time limit.

Prior notification to the FSA and the FSA's approval is also required where an existing controller of an authorized person proposes to increase its percentage shareholding or voting power from less than 20% to 20% or more, or from less than 30% to 30% or more, or from less than 50% to 50% or more. Prior notification to the FSA is also required where an existing controller of an authorized person proposes to reduce its percentage shareholding or voting power below any of the 50%, 30%, 20% or 10% thresholds, but in this case the FSA's approval is not required.

There is a separate and additional obligation on the part of the authorized firm being acquired to notify the FSA about the entity acquiring control of it. The information required from the authorized firm being acquired is similar to that required from the controller.

Usually, both notifications are coordinated and made together to avoid duplication. An authorized firm must also inform the FSA within 14 days after a previously notified change in control has actually taken place.

2. INVESTMENT COMPANY ACT, INVESTMENT ADVISERS ACT AND OTHER REGULATORY ISSUES

a. Client Consents

The client consents that may be required to consummate the transactions will vary based on, among other things, (i) whether the Adviser is registered as an investment adviser under the Investment Advisers Act and (ii) the type of clients the Adviser provides advisory services to and, in particular, whether any of these clients are registered funds. The required client consents should be identified early in the process, because they can significantly affect the timing of the closing of the acquisition as well as the ongoing viability of the acquired Adviser.

The acquisition of an Adviser in the United States, whether by stock purchase, asset acquisition or merger, typically results in an "assignment" of its advisory contracts within the meaning of the Investment Company Act and the Investment Advisers Act. Section 2(a)(4) of the Investment Company Act defines "assignment" to include "any direct or indirect transfer or hypothecation of a contract … by the assignor, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor …." A substantially similar definition appears at Section 202(a)(1) of the Investment Advisers Act. However, there will not be an "assignment" if the transaction does not result in an actual change of control or

management of the Adviser.[3] This requires a facts and circumstances analysis. Once an acquisition agreement is entered into, it is usually necessary to disclose the possible change in control by stickering or amending the prospectuses of registered funds advised by the Adviser.

(1) Registered Fund Clients

An advisory contract with a registered fund terminates automatically in the event of its assignment. Moreover, one cannot serve as investment adviser to a registered fund unless the advisory contract has first been approved by a majority of the fund's directors, including a majority of its independent directors, and by its shareholders.

A sub-advisory agreement with a registered fund must contain the same type of anti-assignment provision. However, often the registered investment company or its primary adviser will have obtained an exemptive order from the SEC permitting sub-advisers to be retained without a shareholder vote.[4] In these circumstances, board approval of the new sub-advisory agreement will be sufficient.

The shareholder vote for the new advisory contract may take several months, a factor in the timing of the closing. The Adviser is generally responsible for the registered fund's proxy costs allocable to the vote to approve the acquisition, and may seek to share this cost with Acquiror. The proxy statement will:

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[3] *See* Investment Company Act Rule 2a-6 and Investment Advisers Act Rule 202(a)(1)-1.

[4] The SEC has granted numerous exemptive orders permitting registered funds to enter into and materially amend subadvisory contracts without shareholder approval. *See, e.g.*, Domini Social Investment Trust and Domini Social Investments LLC, Investment Company Act Release Nos. 29984 (Mar. 21, 2012) (notice) and 30035 (Apr. 17, 2012) (order).

- Describe the transaction and Acquiror, and explain that the existing advisory contracts will terminate when the transaction is consummated.
- Describe the terms of the new advisory contracts, including any material differences from the old.
- Explain why the directors are recommending approval of the new agreement. There will need to be an extensive recitation of the factors considered and procedures followed by the board of directors.
- Address the availability of Section 15(f) protection for the transaction.

Recognizing that in a number of circumstances it may not be possible to obtain shareholder approval of new advisory contracts prior to the closing date, the SEC adopted Rule 15a-4 under the Investment Company Act to provide that a person may continue to act as investment adviser to a registered fund under an interim contract for up to 150 days after an "assignment" of the contract has occurred as a result of an acquisition where the adviser or a controlling person has received money or other benefit, provided that certain conditions are met:

- The compensation to be received under the interim contract is no greater than that under the prior contract and the interim contract contains the same terms and conditions as the prior contract, except for its effective and termination dates and those differences determined by the board of directors to be immaterial.
- The board of directors of the fund, including a majority of the independent directors, has voted in person to approve the interim contract before the prior contract terminates.
- The board of directors, including a majority of the independent directors, determines that the scope and quality of services to be provided to the fund under the interim contract will be at least

equivalent to the scope and quality provided under the previous contract.

- The interim contract can be terminated without penalty on 10 days' written notice by the board of directors or shareholders holding a majority of the voting shares.
- The compensation to be received under the interim contract must be held in an interest-bearing escrow account with the fund's custodian or a bank. If the interim contract is approved by the shareholders within the 150-day period, the Adviser receives the escrowed fees plus interest. If approval is not obtained, the Adviser is paid the lesser of costs incurred or the amount in the escrow account plus interest.
- The fund satisfies certain governance standards (the "Fund Governance Standards"): a majority of the board of directors must be independent directors; those directors must select and nominate any other independent directors; the independent directors must meet in executive session at least quarterly; the directors must conduct an annual self-evaluation; the independent directors must have the authority to retain their own employees and consultants; and any lawyer for the independent directors must be "independent legal counsel," as defined in the rules adopted under the Investment Company Act.

If the conditions of the rule cannot be met, it may be possible to obtain exemptive relief from the SEC. However, this avenue may be impractical since (i) in adopting the Rule 15a-4 amendments, the SEC indicated that the rule essentially codified the exemptive relief the SEC had been willing to give and (ii) the process of obtaining such relief can be quite time-consuming.

(2) Non-Fund Clients

An advisory contract with a non-fund client must state that it cannot be assigned by the Adviser without the consent of the other party to the contract.[5] Failure to obtain consent may be deemed to constitute a breach of the contract.

The SEC staff has issued a series of "no-action" letters that allowed an Adviser to obtain the "negative consent" of its non-fund clients.[6] In these cases, the client should be informed that the Adviser will continue its advisory services for a specified period and that, if the client continues to accept such services without objection, the "new" Adviser will on that basis assume the client's consent to the assignment of the advisory contract. The Adviser may not simply inform its clients that consent to an assignment of their advisory contracts will be assumed from their silence.

The SEC staff subsequently made clear that the Investment Advisers Act requires only that an advisory contract contain a provision prohibiting assignment without consent, and that a purported assignment without consent does not, *per se*, violate the Investment Advisers Act (although it may breach the contract).[7] Accordingly, the validity of consent — negative or written — is determined under state contract law. Reliance on negative consent may be problematic if the advisory contract expressly requires written consent to an assignment. Therefore, a pre-transaction analysis of assignment provisions of advisory contracts is advisable.

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5 *See* Investment Advisers Act § 205.

6 *See, e.g.*, Jennison Associates Capital Corp. (pub. avail. Dec. 2, 1985); Scudder, Stevens & Clark (pub. avail. Mar. 18, 1985).

7 *See* American Century Companies, Inc./J.P. Morgan & Co. Incorporated (pub. avail. Dec. 23, 1997).

Advisers may prefer a negative consent approach as a means of minimizing the correspondence with their clients. However, Acquiror then faces the risk that clients will terminate their advisory contracts after the closing. As a safeguard, Acquiror may seek a purchase price adjustment based on the revenues or assets attributable to clients that terminate their contracts within a specified period following the closing.

If the Adviser sponsors or participates in wrap fee or other managed account programs, the program documents will need to be reviewed carefully to determine whether consents of the underlying clients are required.

(3) Private Fund Clients

If the Adviser manages pooled investment vehicles that are not registered funds, the question of which party can give the required consent will need to be considered carefully. Often the organizational documents of the fund (usually a limited partnership agreement) will be silent on this issue. In other cases, it may appear that the fund's general partner (usually an affiliate of the fund's manager) has the authority to consent to the assignment on behalf of the fund. The disclosure documents related to the fund should also be examined to determine whether they create expectations that limited partners would have an opportunity to approve the assignment. The approach to client consents for private funds often reflects a mix of considerations that are legal (what is required under the various contracts and applicable legal principles) and commercial (how to ensure the continuing goodwill of investors).

b. Underwriting Arrangements

The principal underwriting agreements of a registered fund terminate automatically upon assignment. A "principal underwriter" for an open-end fund is any underwriter who as principal purchases, or has a contractual right to purchase, shares from the open-end fund for

distribution. A dealer purchasing shares through a principal underwriter acting as agent for the fund is not itself considered a principal underwriter. In the case of a closed-end fund, a principal underwriter must either be in privity of contract with the fund or an affiliated person of the fund, initiate or direct the formation of the underwriting syndicate, or be allowed a gross commission or other profit greater than another participating underwriter. Any new principal underwriting agreement must be approved by the fund's board of directors but need not be approved by the fund's shareholders.

An agreement related to the Rule 12b-1 plan of an open-end registered fund must provide for its automatic termination in the event of an assignment, but the plan itself is not required to terminate upon assignment. While the scope of "agreements related to a Rule 12b-1 plan" appears broad, third-party contracts with the principal underwriter of a fund (such as selling agreements with broker-dealers) should not be subject to the requirements of Rule 12b-1, unless the agreements specifically state that they are subject to the rule.

In 2010, the SEC proposed amendments to its rules governing mutual fund distribution. The amendments would replace Rule 12b-1 with a new rule that would continue to allow registered funds to bear the costs of distributing and marketing fund shares within certain limits. The proposed amendment would also limit the cumulative sales charges each investor pays, no matter how they are imposed. The proposals met a significant amount of opposition from the industry and it is unlikely that the SEC will pursue adoption of these amendments in the near term.

c. Profits from the Sale of an Investment Company Adviser

Under common law, a fiduciary is generally prohibited from selling its office for personal gain, because the fiduciary may be placing its interests before those of its clients in the sale. However, Section 15(f)(1) of the Investment Company Act provides that, subject to certain conditions, the Adviser of a registered fund, or an affiliated person of the Adviser, "may receive any amount or benefit in connection with a

sale of securities of, or a sale of any other interest in, such investment adviser ... which results in an assignment of an investment advisory contract"[8] of such fund. The conditions to this exemption include the following:

- For at least three years after the transaction, at least 75% of the members of the board of directors of any fund advised by the Adviser must be independent of the Adviser (both pre- and post-acquisition). Acquiror therefore should take care not to unduly influence the selection of the new independent directors. However, if independent directors do not comprise 75% of the fund's board, Seller and Acquiror may wish to encourage the independent directors to seek out additional independent directors in anticipation of the transaction. The independent directors of the fund should be surveyed for any relationships with the Acquiror that could bear on their "independence" for this purpose.

- The acquisition may not impose an "unfair burden" on any fund advised by the Adviser. Under Section 15(f)(2)(B) of the Investment Company Act, an "unfair burden" includes any arrangement during the two-year period after the acquisition whereby the Adviser or any interested person of the Adviser receives any compensation, directly or indirectly: (i) from any person in connection with the purchase or sale of securities or other property to, from or on behalf of the fund, other than bona fide ordinary compensation as principal underwriter for such fund; or (ii) from the fund or its shareholders for other than bona fide investment advisory or other services.

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8 Section 15(f) of the Investment Company Act applies to a sale of securities of an Adviser, as well as "a sale of any other interest in" the Adviser that results in an "assignment" of its advisory contracts. In view of the broad definition of the term "assignment" under Section 2(a)(4) of the Investment Company Act, Section 15(f) covers the purchase of an Adviser's assets in addition to a purchase of its stock.

The bearing by a registered fund of any of the costs caused by the acquisition of an Adviser — including costs associated with a special shareholders meeting — may constitute an unfair burden. Management fee increases during the two-year period may also raise issues of unfair burdens. Some Advisers may seek to include non-acquisition matters in a proxy statement seeking approval of a transaction. The allocation of costs will be subject to special scrutiny in these circumstances. Acquirors and their advisers should be careful about generating analytical documents that could be damaging in a Section 15(f) litigation (*e.g.*, "XYZ Fund Management's margins could be improved significantly if it reduced services and increased fees"). Large transactions can attract Section 15(f) litigation and participants should plan accordingly.

d. Dealing with Fund Directors

If the Adviser has registered fund clients, it will be necessary to approach the directors of the funds for their approval of new advisory agreements effective upon the change of control of the Adviser. If the independent directors are represented by counsel, the counsel must be "independent legal counsel," as defined by Rule 0-1(a)(6) under the Investment Company Act. Essentially, this means that if the counsel, or his or her law firm, receives any significant fees from the Adviser or its affiliates, the lawyer will not be independent. If the independent directors' counsel is not independent, the fund complex will not be entitled to rely on a number of important exemptive rules, including Rule 15a-4, Rule 12b-1 and several exemptive provisions under Section 17 of the Investment Company Act. Therefore, Acquirors will want to ascertain early whether the independent directors are represented by their own counsel and whether that counsel is "independent."

Generally, registered funds have either an independent chairman of the board or an independent lead director, which can heighten the need for sensitivity to process issues when approaching the board.

Practical, timing-related issues involving communications with a registered fund's independent directors are as follows:

- If given early notice, will the directors then be tempted to run an auction, to see who will be the best manager for the lowest advisory fee? Is there more likelihood that advisory personnel will leave the Adviser if they learn early that the Adviser may be up for sale?
- Is it practical to wait until just before the announcement of the transaction?
- As an in-between approach, the fund directors may be told at the outset that the Adviser is reviewing its strategic alternatives, including a possible sale of the Adviser, but that any transaction would be done only with a reputable purchaser and only with the approval of the fund directors. The Seller should also initiate communication with counsel to the funds and counsel to the independent directors in order to ascertain their concerns.
- There is always a risk, once the transaction is announced, that a third party may submit a proposal to the fund directors (*e.g.*, "choose us instead of the announced proposed buyer; we'll provide as good or better services, but for a lower fee"). Whether there is a high risk of this depends on many factors. The risk is reduced if, for example: (i) the fund has performed well; (ii) the incumbent Adviser has been charging relatively low fees; (iii) the fund's expense ratios have been low; (iv) fund directors have had a good relationship with the incumbent Adviser; (v) the incumbent Adviser will continue in business, with some or most of the existing managers; and (vi) the proposed Acquiror has a good reputation and financial strength.

An Acquiror that currently manages its own family of registered funds may also want to consider the challenges presented by managing two or more groups of funds with separate boards of directors. Multiple fund boards will likely require that more of Acquiror's time and resources be

devoted to Board relations after the closing. Different boards may also demand different approaches to audit, compliance and operational issues that may be difficult to resolve. They may also make it more difficult to rationalize Acquiror's "product" offering through mergers of funds that offer similar investment strategies. In some instances, it may be possible to combine the boards or to persuade the directors of the acquired funds to step down. Ultimately, these decisions rest with each board of directors. Discussing these issues requires a great deal of diplomacy and sensitivity.

Under Section 15(c) of the Investment Company Act, the fund's directors have the duty to request, and the Adviser has the duty to provide, such information as may reasonably be necessary to evaluate an advisory contract. The directors should be assured that all relevant information will be provided to them, that the contract will continue only if approved by them, and that there will be no diminution in services to the fund and no imposition of an unfair burden on the fund. In some cases, Acquirors have also sought to appeal to the directors by proposing reduced fees or increased services, or by making other representations regarding their intentions and plans for change (or lack of such plans).

The standards for approving an advisory contract under Section 36(b) of the Investment Company Act have been generally well understood. Section 36(b) of the Investment Company Act provides that an investment adviser is deemed to have a fiduciary duty "with respect to the receipt of compensation for services" paid by a registered fund. The Supreme Court, in *Jones v. Harris Associates, L.P.,*[9] concluded that the basic standard that has been applied in evaluating advisory contracts (the *Gartenberg* standard) is "correct in its basic formulation of what [Section 36(b)] requires" but reminded the courts and registered fund boards that "all relevant circumstances must be taken into account." Recent claims under Section 36(b), for example, have focused on issues arising under

[9] 130 S.Ct. 1418 (Mar. 30, 2010).

so-called "manager of managers" arrangements pursuant to which an investment company's primary investment adviser retains, and pays a portion of its fee to, one or more sub-advisers that assist it in managing the investment company' assets. Thus, an Acquiror should be prepared to respond to questions concerning a broad range of issues that relate to the new investment management agreement with a registered fund.

e. Acquisitions by Broker-Dealers

If Acquiror or any of its affiliate is a broker-dealer (a "Broker"), care must be taken to ensure compliance with the provisions of the Investment Company Act and the Advisers Act restricting principal and agency transactions between an advisory client and the Adviser and its affiliates, as well as other broker-dealer regulatory requirements.

If a registered fund advised by the Adviser purchases securities through the Broker, the commission, fee or other remuneration paid to the Broker must not exceed the usual and customary broker's commission for such transactions. Rule 17e-1 under the Investment Company Act provides that such a commission will not be deemed to exceed this standard if (a) it is reasonable and fair compared to commissions received by other brokers in connection with comparable transactions; (b) the fund's board of directors, including a majority of the independent directors, has adopted and observes prescribed procedures to ensure compliance with the standard; (c) the fund maintains specified records of the procedures and transactions; and (d) the fund satisfies the Fund Governance Standards.[10] Similar issues may arise under the Investment Advisers Act, to the extent that the Adviser has traditionally directed client trades to the Acquiror's broker-dealer.

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10 *See supra* note 5. All of the Investment Company Act rules described in this paragraph incorporate the Fund Governance Standards as a condition for relying on the rule.

Although Section 10(f) of the Investment Company Act generally prohibits a registered fund from purchasing securities of which an affiliated Broker is a principal underwriter, Rule 10f-3 under the Investment Company Act permits such purchases under specified conditions.

Section 17(a) of the Investment Company Act generally prohibits a Broker from entering into principal transactions with an affiliated fund. Rule 17a-7 provides an exemption for certain cash transactions effected at the independent current market price of a security, where no brokerage commission, fee or other remuneration (other than customary transfer fees) is paid.

Section 17(d) of the Investment Company Act generally prohibits any affiliated person of a registered fund from entering into any transaction in which the affiliate is a joint or joint and several participant with the fund. The staff of the SEC interprets the term "joint transaction" extremely broadly. Accordingly, exemptive relief pursuant to Rule 17d-1 should be considered for transactions that appear to raise issues under Section 17(d).

A Broker affiliated with an Adviser that enters into principal transactions with clients of the Adviser may be subject to the provisions of Section 206(3) of the Investment Advisers Act. That section provides that an Adviser may not, directly or indirectly, engage in principal transactions with a client unless the Adviser first makes written disclosure to the client and then obtains prior approval from the client on a transaction-by-transaction basis. However, Rule 206(3)-2 allows an Adviser to obtain prospective written authorization from clients to effect "agency cross transactions," in which the Adviser or an affiliate of the Adviser acts as broker for both an advisory client and for another person on the other side of the transaction. If Acquiror is a Broker, the process by which it proposes to effect any agency cross transactions should be evaluated.

f. Other Regulatory Matters

- The Adviser's Form ADV must be amended "promptly" to reflect any changes in the Adviser's control persons and owners with a 5% or greater interest in the Adviser, and to address changes required by the addition of new "related persons," among other things. During this update process, one should consider whether any new conflicts of interests that may be raised by the Adviser's relationship with the Acquiror require disclosure in the Adviser's Form ADV.

- Similar amendments to the disclosure regarding control persons and additional disciplinary proceedings would be required to be made to Form BD if the Adviser or an affiliate is a registered broker-dealer.

- If the Adviser or one of its affiliates that will be part of the transaction is registered as a commodity trading adviser, a futures commission merchant or a commodity pool operator ("CPO"), the Adviser must submit required filings to the Commodity Futures Trading Commission (the "CFTC") following the transaction to reflect the change of control. The CFTC recently repealed Section 4.13(A)(e) of the CFTC Regulations, which exempts CPOs from CFTC registration where the pools are offered only to qualified eligible persons. While certain CPOs may be able to rely on different exemptions, many CPOs who engage in more than *de minimis* commodity trading may be required to register with the CFTC. The costs of registration and the impact of registration on the CPO's operations should be assessed if the CPO is not already registered.

- Depending on the size of the transaction, a notification under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, may be required, and the transaction may be subject to the applicable waiting period. See Section 3.a of Chapter One and Chapter Five. Considerations should also be

given as to whether any non-U.S. competition law filings should also be made.

- If the advisory clients of the Adviser include ERISA plans, diligence should be undertaken as to ERISA compliance. For example, if the Adviser is intended to be a "Qualified Professional Asset Manager" under PTCE 84-14 of ERISA, or if the Adviser has been using the statutory "service providers" exemption in its transactions, Acquiror should ensure compliance with these exemptions. Where either Acquiror or Adviser is an affiliate of a larger financial institution, integrating the ERISA compliance function is often a necessary and complicated task.
- If Acquiror is subject to the U.S. banking laws, the transaction will present additional bank regulatory issues. If the bank is relying on the financial holding company provisions of the Gramm-Leach-Bliley Act, or intends to qualify as a financial holding company, the impact on the transaction will need to be fully explored, including any timing considerations. Acquiror may seek representations that the transaction will not cause Acquiror to violate the Bank Holding Company Act and applicable state and federal banking regulations and likely will seek extensive information from the Adviser about its investments and activities. Acquiror will also need to consider how it will comply with the Volcker Rule enacted as part of the Dodd-Frank Act.
- Depending on the nature of the parties, additional consents or notices may be required under state law, for example in respect of state insurance regulators or state banking authorities.
- If Acquiror or Seller is a non-U.S. person, additional approvals or filings may be required under the laws of the applicable foreign jurisdiction.
- The Seller may have obtained exemptive orders from the SEC under the Investment Company Act or no-action letters from

the SEC staff that are important to its operations. A determination must be made whether Seller will be able to continue to rely on those orders and no-action letters after the closing, particularly if the transaction takes the form of a merger or a sale of assets.

- Where the Acquiror or one of its affiliates has acted as custodian for one of the Adviser's clients (other than registered funds), additional regulatory burdens may be imposed under the Investment Advisers Act's custody rule.
- If any of the Adviser's clients or investors in the pooled investment vehicles advised by the Adviser are state and local government entities, the political contributions of the Acquiror and certain of its directors, officers and employees should be carefully reviewed for compliance with the "pay to play" rule under the Investment Advisers Act and other applicable state and local laws.
- The SEC has recently adopted a new reporting form for registered investment advisers that manage private funds – Form PF. Form PF imposes burdensome requirements on many private fund managers, which should be taken into account in assessing ongoing compliance costs.

3. SPECIAL TAX PLANNING ISSUES

a. Form of the Transaction

In general, it is advisable for Sellers and Acquirors to understand the tax benefits and detriments of each form of transaction under the federal, state and local tax laws applicable to the Adviser, Acquiror and Seller.

For example, if Acquiror is a partnership or is otherwise not taxable as an entity (for example, a limited liability company), and the Adviser is taxable as a corporation, Acquiror may wish to acquire the Adviser

through an asset purchase rather than through a stock purchase (or to have the flexibility to liquidate the Adviser shortly after the transaction), in order to avoid operating the business through a taxable entity that will be subject to an extra level of taxation on the Adviser's income earned after the acquisition. In the U.S., asset acquisitions (and stock purchases treated for tax purposes as asset acquisitions) will also (subject to limitations described above) generally cause the tax basis of the assets to be written up (or down) and so may serve to increase post-acquisition deductions.

When the Adviser is taxable as a "Subchapter C" corporation (and not a corporate subsidiary), an asset acquisition is normally not advisable because of a potential double taxation of the Seller. In addition, if the Adviser is structured as a partnership or limited liability company and conducts its business in New York City, gain from a transaction structured as an asset sale could be subject to the New York City Unincorporated Business Tax (currently imposed at a 4% rate), whereas a sale of partnership or membership interests may be structured so as to avoid the UBT. An asset acquisition may also be subject to sales and transfer taxes that would not apply in a stock sale.

Intangible assets acquired in an asset purchase (*e.g.*, client lists, management contracts, covenants not to compete, goodwill and going concern value) are to be amortized for tax purposes over a period of 15 years. However, if some or all of the Sellers will retain an equity interest in the Adviser, amortization deductions for the increased basis in goodwill and some other intangibles may be limited under the "anti-churning" rules of Section 197 of the Internal Revenue Code.

b. Competing Goals of Acquiror and the Selling Shareholders of the Adviser

If the Adviser and Acquiror are taxed as corporations, the transaction may be structured as a tax-free exchange, if the selling shareholders of the Adviser exchange their shares of stock for shares of Acquiror (or shares of a holding company that holds the Adviser). Acquiror will not

receive any basis write-up in the assets of the Adviser. If the transaction can be structured as a tax-free exchange, the tax benefit to the selling shareholders and the tax detriment to the Acquiror may be reflected in the purchase price.

If the selling shareholders receive notes or other deferred payments (instead of cash at closing), they may be able to defer gain on the transaction. However, holders of the notes may be required to pay interest to the IRS on any deferred taxes and a portion of any deferred payment will usually be taxed to the recipient as ordinary interest income (even if an interest component is not separately stated).

The federal income tax treatment of management incentive payments may also result in a significant divergence of interests. If any portion of the deferred purchase price paid to a seller/manager of the Adviser is contingent upon the recipient's performance of services following the closing, that portion will likely be taxable at ordinary income (rather than lower capital gain) rates, and may be subject to employment taxes. Note, however, that in addition to furthering the Acquiror's goal of retaining key employees, such deferred payments will likely be immediately deductible when paid (rather than capitalized and possibly amortized over 15 years) — providing an additional tax benefit to the Acquiror that can be taken into account in pricing. The treatment of such payments for financial reporting purposes must also be taken into account for some Acquirors as payments tied to the continued performance of services can reduce reported earnings.

c. Asset Allocations

In a transaction structured as an asset acquisition (or treated as an asset acquisition for tax purposes), the allocation of the purchase price among the purchased intangibles will usually not be especially significant for Acquiror. As noted, in the U.S., the entire purchase price allocable to intangibles will (subject to the anti-churning rules mentioned above) generally be amortized over 15 years. However, Seller may be keenly interested in an agreed allocation. The amount of the purchase price

allocated to some intangible assets – for example, investment management contracts themselves – may generate ordinary income to Seller, while the purchase price allocated to other intangibles – for example, customer-based intangibles or goodwill – may produce capital gains, taxed at substantially lower rates for individuals. In circumstances in which the investment management contracts may be cancelled on relatively short notice, or investors are free to withdraw invested assets from target-advised funds over a short period of time, it will likely be perfectly appropriate to conclude that substantially all of the value of the business is in goodwill or other customer-based intangibles, and not in the contracts themselves. While an allocation that is agreed on by the parties is not binding on the IRS, it is generally believed to be helpful for Seller and Acquiror to report the transaction in a consistent manner for both tax and financial accounting purposes.

d. U.S. Holding Company for Foreign Purchaser

Acquirors organized outside of the U.S. can be subject to income tax rates that may be higher than those in the U.S. In such cases, an Acquiror purchasing a U.S. Adviser may wish to form a U.S. acquisition vehicle or holding company to hold its interest in the Adviser's U.S. operations. Depending on the tax reporting requirements of Acquiror's home jurisdiction and applicable tax treaties, it may be possible for the income earned through the Adviser to remain at the U.S. company, without being subjected it to the higher foreign tax rate. If a foreign Acquiror has other operations in the U.S., it may be desirable to include the Adviser's U.S. operations under a U.S. holding company that can be included in a consolidated group of U.S. subsidiaries of Acquiror filing a single U.S. income tax return, so that income and losses of different subsidiaries can be offset and overall tax liability reduced. If the target Adviser has non-U.S. operations, it may be worthwhile to consider structuring the acquisition so that profits from non-U.S. operations are not taxed both in the jurisdiction of operation and in the U.S.

e. FIRPTA Certificates

Under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), if the Seller is a non-U.S. person and Acquiror will acquire a U.S. real property interest in the transaction, Acquiror is required to deduct and withhold a tax equal to 10% of the amount realized by the Seller.[11] An Acquiror may be required to withhold taxes from the purchase price, even if, as a substantive matter, the transaction is not subject to FIRPTA, unless the Seller provides appropriate certificates in the form prescribed under Treas. Reg. § 1.1445-2.

f. Allocation of Adviser Taxes

Acquiror and the Seller should come to an agreement as to their respective liability for taxes on the Adviser's business before and after the closing. Ordinarily, the parties agree on the person or persons responsible for preparing tax filings and making any applicable tax elections, and agree to consult and cooperate with one another with regard to such tax matters.

4. REGULATORY DUE DILIGENCE

A major compliance issue, or an enforcement proceeding against a key officer or employee, can impose significant costs, in terms of both out-of-pocket expenses and damage to the Adviser's reputation. Key questions in this area include the following:

- Has the Adviser been subject to any major compliance issues in the past? Are there currently any major outstanding compliance issues?

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11 *See* I.R.C. § 1445 and Treas. Reg. § 1.1445-1.

- Does the Adviser have in place policies and procedures reasonably designed to ensure compliance with applicable laws? What is the attitude of senior management toward compliance? What qualifications does the chief compliance officer have? Who controls the compensation of the chief compliance officer?

- What is the Adviser's approach to dealing with conflicts of interests?

- Does the Adviser manage money market funds? Has it made any commitments to provide credit support for securities that are held by such funds? Note that the approach to regulating money market funds continues to be a contentious issue at the SEC and among other federal regulators.

- Specific items to review include: the Adviser's compliance manual and procedures, records of any regulatory inspection or examination by the SEC, FINRA or its predecessor or state regulators, annual or other reports of the chief compliance officer of Seller or the Funds' auditors' "management letters" on internal controls, compliance officer files on compliance policies of fund service providers, any internal audit reports or investigations.

Diligence should focus on current or historic regulatory "hot-button issues," such as safekeeping of client assets, "pay to play", portfolio valuation, market-timing, late trading and portfolio disclosure issues, "revenue sharing" and similar distribution arrangements, controls on non-public information that are designed to limit trading on such information, business continuity plans, anti-money laundering compliance, privacy issues, soft dollars, new issue allocations, best execution, personal securities transactions, agency cross transactions, and Investment Company Act Rule 2a-7 compliance (for money market funds). As noted above, it is often appropriate to seek specific representations concerning these issues.

Investment advisers and private funds are not currently required to implement an anti-money laundering compliance program under the Bank Secrecy Act and related regulations. Nonetheless, many investment advisers will implement anti-money laundering and "know your customer" programs in response to requests from financial counterparties and investors. An Acquiror should confirm that any entity managed by the adviser is in compliance with all applicable anti-money laundering and anti-terrorist laws and regulations.

CHAPTER NINE —INVESTING IN LLOYD'S

JEREMY HILL[1]

1. PRELIMINARY

a. What is Lloyd's?

Although Lloyd's has one of the most famous and (after 324 years) long-established brand names in the commercial world, and the story of its origins in Edward Lloyd's coffee house in the 17th century City of London is well known, the present structure and operation of Lloyd's, and the insurance entities that fall within its regulatory governance is less widely known.

Before considering the types of entity that are permitted to trade in, and together comprise, Lloyd's it may be helpful to consider Lloyd's position as an insurance and reinsurance entity in the global marketplace. Indeed, Lloyd's is the leading (some would say the only) insurance market in that no other body has consolidated so many different insurance underwriters and intermediaries, together with a market structure to process premiums and claims and issue policies, regulated by a common regulator, within one geographic location. In addition, no other insurance body has yet secured for its members a global franchise which enables them, by reason of being within the Lloyd's franchise, to underwrite insurance and/or reinsurance business in more than 200 countries and territories worldwide.

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[1] Jeremy Hill is a partner in the London office of Debevoise & Plimpton LLP and a global co-chair of the firm's Financial Institutions Group. ©2012 Debevoise & Plimpton LLP. All rights reserved. Portions of this chapter may appear in other materials published by the author or his colleagues.

According to Lloyd's published statistics for 2011[2]:

- The Lloyd's market had gross written premium income of approximately £23.5 billion, spread across 88 syndicates underwriting at Lloyd's
- 97% of the companies that make up the Dow Jones Industrial Average and 94% of FTSE 100 companies have policies with Lloyd's
- The Lloyd's market is rated A+ by Fitch Ratings and Standard & Poor's and A (Excellent) by A. M. Best
- Lloyd's combined ratio of 106% exceeds the average for US P&C insurers and for US reinsurers[3]
- Of the underwriting capital that now supports Lloyd's over 49% comes from the international insurance industry principally from the USA and Bermuda
- Total pro-forma resources of Lloyd's and its members are approximately £60 billion

b. Types of Lloyd's entity

(1) The Society of Lloyd's

Lloyd's is not an insurance company itself, and accepts neither premiums nor insurance risks. Lloyd's is a society which operates a marketplace in which entities that are licensed by Lloyd's, whether to

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[2] Lloyd's Financial Highlights as at 31 December 2011.

[3] The average combined ratio for US P&C insurers and US reinsurers in 2011 was 107.2%, as calculated by the Reinsurance Association of America.

broker insurance business or to underwrite insurance and reinsurance risks, can operate. The Society of Lloyd's was incorporated by statute in 1871 and its powers derive from a series of private Acts of Parliament known as Lloyd's Acts 1871 to 1982. The governing body of the society is the Council of Lloyd's which has control over the management and regulation of Lloyd's and the power to make rules and regulations to direct the conduct of business in the Lloyd's market and the exercise of disciplinary powers over market participants.

Under the authority of the Council, a franchise operation has been developed at Lloyd's since 2003 whereby the central market operations are conducted by the Corporation of Lloyd's which acts as a franchiser and has established the "Lloyd's Franchise", a set of objectives and rules to govern the operation of the marketplace and to which the independent franchise participants who underwrite insurance business in the Lloyd's market must adhere.

The aim of the Lloyd's Franchise is for Lloyd's to be consistently high performing and the leading specialist insurance marketplace. The Franchise has three core objectives:

- To create and maintain a commercial environment at Lloyd's in which the long-term return to all capital providers is maximized
- To make Lloyd's the market of choice for policyholders, brokers, underwriters and capital providers
- To create a disciplined marketplace of well-managed businesses

Lloyd's stated role as franchisor of the Lloyd's insurance market is that of proactive and prudent commercial management. This role encompasses three core streams of activity:

(i) Capital Management

- Lloyd's Risk Based Capital (RBC) model determines the level of capital a member is required to place at Lloyd's in support of their underwriting, and promotes the efficient distribution of capital in relation to risk.

(ii) Franchise performance

- underwriting review and business planning to facilitate a structured, disciplined approach to underwriting
- performance benchmarking: to identify underperformance at the earliest opportunity
- claims and reinsurance management: to ensure "best practice" is implemented marketwide.

(iii) Risk management

- syndicate risk assessment: provides clear focus for risk management reviews
- Realistic Disaster Scenarios (RDS): Lloyd's RDS framework seeks to manage catastrophe exposure at both a syndicate and market level.

Obvious benefits for franchisees who are licensed to operate in the Lloyd's insurance market include the benefit from Lloyd's central resources, including the Lloyd's brand and, crucially, Lloyd's strong single market rating and the benefit of Lloyd's global license to transact insurance business.

In November 2001, regulatory responsibility for the Lloyd's market was assumed by the Financial Services Authority, the regulatory body for the entire United Kingdom financial sector. Under the Financial Services & Markets Act 2000, the regulation of Lloyd's was passed to the Financial Services Authority but only on an overall supervisory basis, and whilst the Financial Services Authority has statutory powers to intervene in the Lloyd's market and has its own regime for approval of syndicate managing agents and brokers operating within the Lloyd's market, the responsibility for day to day operations and for rule-making within the Lloyd's market remains with the Council of Lloyd's.

(2) Members of Lloyd's

The original members of the Society of Lloyd's were wealthy merchants and private individuals of means who underwrote marine insurance risks that arose from the UK's status as the leading maritime trading nation, and maritime power, of the 18th and 19th century. As the need arose for increasing capital available for underwriting, wealthy individuals from outside the merchant and shipping community were invited to become members and Lloyd's continued to have a membership comprised entirely of individual members (known as "Names") until 1994.

Favorable tax concessions and the ability to pledge assets rather than deposit them with Lloyd's (thus enabling a Name to use assets twice, for example by way of pledging the family estate to support Lloyd's underwriting yet still retaining the ownership of and income from the estate) were offset by the unlimited personal liability that Names assumed for the insurance risks to which they subscribed.

Following estimated total losses of £9.5 billion in the years 1988 to 1992 for which individuals as Names at Lloyd's were personally (and unlimitedly) liable, the survival of Lloyd's depended on its ability to introduce new capital, which in turn was only available from corporations wishing to underwrite at Lloyd's with the benefit of limited liability. With effect from 1994, Lloyd's therefore allowed corporate entities to become members at Lloyd's and immediately some 95 new corporate members joined Lloyd's as limited liability members and provided an additional £1.5 billion of underwriting capacity to the market.

The capital required to support (re)insurance underwriting at Lloyd's is provided by the Members, who participate on Lloyd's syndicates. Whilst unlimited liability personal membership was the norm before 1994, unlimited liability individual Members now provide only 3% of the capital at Lloyd's, with the international insurance industry and other investors (including private equity and hedge funds) providing the overwhelming majority of capital on a limited liability basis.

The introduction of limited liability participation by corporate members at Lloyd's has also had the effect of reducing the number of syndicates in operation. Whereas private individual members typically support and underwrite on a number of syndicates, a corporate member usually only underwrites on a single syndicate managed by a managing agent under common ownership with the corporate member, hence creating a quasi insurance company (or in Lloyd's parlance, an "integrated Lloyd's vehicle" or "ILV") as discussed further in paragraph (3) below.

As the ongoing movement in the worldwide insurance cycle leads corporations to increase or reduce their capital committed to Lloyd's, M&A activity has developed with regard to corporate participation at Lloyd's (see section 2 below).

(3) Syndicates

Members of Lloyd's conduct their insurance underwriting activities through membership of one or more syndicates at Lloyd's.

A syndicate is not a legal entity but is an administrative grouping of one or more members of Lloyd's into a collective body which is managed by an authorized Managing Agent (see paragraph (4) below) and for which an authorized individual appointed by the Managing Agent acts as the "active underwriter". The active underwriter has full authority from the members of the syndicate under an Agency Agreement on terms prescribed by Lloyd's to accept insurance and reinsurance risks on their behalf, up to an aggregate overall limit of premium for the syndicate itself.

Syndicates are an annual venture and each syndicate (at least in theory) is reconstituted for each underwriting year so that members may join or leave the syndicate and the managing agent may elect to increase or decrease the size of the syndicate or the types of insurance business it underwrites from year to year.

Insurance business written through a syndicate at Lloyd's is written on a several, (and not joint or joint and several), basis by each syndicate

member according to his proportionate allocation (or "share") of the syndicate's overall share of each insurance risk. Given that Lloyd's is a subscription market and that risks are unlikely to be underwritten as to 100% by any one syndicate, each risk underwritten at Lloyd's will likely have a number of syndicates subscribe to underwrite that risk on a several basis as between syndicates and on a several basis as between the members of each syndicate participating in the underwriting of the risk.

Membership of Lloyd's syndicates was formerly in the gift of the managing agent, but with effect from the 1995 underwriting year of account Lloyd's introduced a system of "pre emption rights" with regard to syndicate membership so that thenceforth syndicate members would have a prima facie pre-emptive right to continue to participate on a syndicate (if they so elected) and to take up their pro rata share of any underwriting capacity available on a syndicate following any increase in the overall underwriting capacity of the syndicate. Through a system of capacity auctions, Lloyd's also now permits the trading of syndicate memberships, thus establishing a mechanism for syndicate membership to be valued and traded in the auctions.

Following the introduction of corporate membership at Lloyd's in 1994, syndicates have increasingly become dominated by corporate members, often by corporate members owned by or in the same corporate ownership as the managing agent of the syndicate; this has had the effect of creating quasi insurance companies within Lloyd's whereby the underwriting capital deployed and the ownership of the licensed entity through which such capital is deployed are in the same shareholder ownership.

(4) Managing Agents

Before the introduction of corporate capital to Lloyd's in 1994, the managing agent at Lloyd's was often a company established (and owned as to a significant percentage by) individual underwriters at Lloyd's who had built up a reputation and skill in underwriting a particular class or classes of insurance-business and thus attracted support from Names

who wished to join the syndicate(s) managed by that managing agent and brokers who wished to place insurance risks with that underwriter.

With the advent of corporate capital, the model has changed so that more often than not the managing agent at Lloyd's will now be owned by a corporate entity (often an insurance group independent of the Lloyd's market, and often publicly traded) and the underwriter will be an employee rather than proprietor. The essential role of the managing agent has remained unaltered however, and the 57 managing agents which for 2011 managed the affairs of 88 syndicates at Lloyd's remain responsible for the approval and supervision of arrangements for:

- acceptance and pricing by the active underwriters of the risks to be underwritten and the receipt of the premiums agreed with brokers
- agreement and settlement of claims made against the syndicate
- negotiations and management of the syndicate's reinsurances
- management of the investments held in the Premiums Trust Fund of each syndicate member
- management and control of the syndicate's expenses
- monitoring and controlling the premium income earned by the syndicate and taking reasonable steps to ensure that member's syndicate premium limits are not exceeded
- the maintenance of accounting records and statistical data for the syndicate and the preparation and audit of the syndicate's accounts
- making, where necessary, cash calls on members to provide for underwriting losses
- compliance with relevant domestic and overseas taxation and legislative requirements
- approval of the premium for, and effecting, the reinsurance required to close each year of account.

As well as ILVs and aligned syndicates which are managed and funded by entities within the same corporate group, and syndicates which are supported by a number of different members (which can include both private capital and corporate groups) who provide capital to the syndicate but are not connected with the managing agent (hence known as "unaligned syndicates"), there are also syndicates established under a "turnkey" model where an existing managing agent establishes and manages a syndicate solely on behalf of a third party capital provider (sometimes a major industrial company seeking a quasi-captive insurer or another insurer seeking a specialist niche participation in (re)insurance risks brokered at Lloyd's).

(5) Members' Agents and Lloyd's Advisors

It is a requirement of Lloyd's that each individual Name (as opposed to a corporate member) must appoint a members' agent to advise him or her on their underwriting affairs at Lloyd's. The relationship between the Name and the members' agent is governed by a prescribed form of Agency Agreement whereby the members' agent, whose principal role is to advise on syndicate membership selection and participation by the Name, is appointed under an agreed fee and profit commission arrangement. The members' agent essentially acts as a conduit between the managing agents (on whose syndicates the Name underwrites) and the Name, providing advice on market and regulatory developments and assisting in investment of the Names funds at Lloyd's and any capacity auctions or transfers by the Name.

As the number of individual Names has declined, so has the number of members agents reduced from 34 in 1994 to 4 as at the date of this publication.

With regard to advising corporate members of Lloyd's, perhaps in recognition of their limited liability status and the fact that many corporate members are owned by insurance companies and hence are akin to market professionals, Lloyd's rules permit corporate members to appoint a Lloyd's adviser or a members' agent or opt out of doing so.

(6) Lloyd's Brokers

Brokers have played an important part in the development of Lloyd's, particularly in introducing North American insurance and reinsurance risks to the market. The primary regulation of brokers has now been assumed by the Financial Services Authority so that Lloyd's regulatory role as regards brokers is today limited to granting brokers "accreditation" to permit them to broker insurance risks to Lloyd's syndicates. At the end of 2011 there were 186 firms of Lloyd's brokers.

2. WHY INVEST IN LLOYD'S?

The Financial Services and Markets Act 2000 categorizes as "investments" both:

(i) "the underwriting capacity of a Lloyd's syndicate" (i.e., a syndicate participation)

(ii) "a person's membership (or prospective membership) of a Lloyd's syndicate".

Accordingly, to advise in connection with or recommend or enter into contracts relating to these "investments" is a regulated activity in the United Kingdom for which a person will need an FSA authorization or fall within an applicable exemption. In consequence, promotion of Lloyd's membership and the potential advantages is conducted carefully and promotional literature is restricted in its circulation, but reasons put forward for investing in Lloyd's include:

(i) investment into a specialist insurance market that has the capability of producing high returns: recent return on capital percentages for the Lloyd's Market as a whole range from 31.4% for 2006 to 12.1% for 2010. For the first time in six years, Lloyd's posted a loss in 2011, with a -2.8% return on capital, due to the highest ever year of claims at Lloyd's.

(ii) double use of assets : assets pledged or deposited to provide capital to support underwriting at Lloyd's can effectively provide two potential income streams, i.e. profits from the underwriting and the investment return earned on those assets

(iii) limited liability investment : subject to any separate guarantees or support obligations that the investor might give, the participation in Lloyd's can be structured as a limited liability participation (unlike the historic unlimited liability individual membership of Lloyd's)

(iv) benefit of the 'mutualized' Lloyd's Central Fund which stands as ultimate security for policies underwritten at Lloyd's by members

(v) transferability of the Lloyd's participation, either through disposal of a corporate member or an interest therein through an M&A transaction or through disposal of syndicate participations (e.g. through sale in the Lloyd's Capacity Auctions)

(vi) exposure to a non-correlated asset class : this may be of particular interest to private equity and hedge fund investors

(vii) tax planning opportunities : including potential pension and inheritance tax benefits for UK individuals and tax domicile and reinsurance opportunities for corporate investors

(viii) a geared participation : for every £1 deposited or pledged the investor should be able to underwrite more than £1 of premium income

(ix) the ability to finance participation through debt instruments and third party guarantees and letters of credit

3. ROUTES INTO LLOYD'S

Potential opportunities to invest in Lloyd's are available both to private investors and to corporate participants although Lloyd's no longer permits private individuals to join as unlimited liability members.

Investment opportunities range from those that are close to or involve actual underwriting to those that are an investment in securities with an exposure to Lloyd's (such as an investment in one of the many publicly-traded corporate groups that own businesses trading at Lloyd's).

a. Individuals:

- investment directly in a corporate member of Lloyd's established as a limited liability entity and participating on a number of syndicates
- syndicate participations may be selected by or sourced through a Lloyd's member's agent or advisor
- syndicate participations may be acquired or disposed of through the Lloyd's Capacity Auctions
- exit routes include sale of the interest in the corporate member and/or sale of the syndicate participations held by the corporate member
- investment in a publicly-quoted corporate group with business(es) at Lloyd's.

b. Corporate and professional investors:

- investment in a corporate member
- corporate member may underwrite on one or more syndicates also established by the investors and managed by a managing

agent also established by the investors (i.e. an ILV structure) or through a third party managing agent

- providing regulatory capital by way of "Funds at Lloyd's" to support underwriting at Lloyd's by investor's corporate member(s) or by third party corporate member(s)
- investment in or outright acquisition of existing ILV structures
- setting up a "turnkey syndicate' operation
- investment in a publicly-quoted corporate group with business(es) at Lloyd's.

4. TRANSACTION ISSUES

a. Acquisition Landscape

Over the past 18 months, there has been significant M&A activity in the Lloyd's market, including a number of transactions that involved public London listed corporate members. As at July 2012, Brit, Chaucer, Hardy have been acquired and delisted.

Brit Insurance was acquired by Apollo and CVC, Chaucer by The Hanover Insurance Group and Hardy by CNA Financial Corporation. Subject to the completion of regulatory conditions, another listed Lloyd's (re)insurer, Omega is expected to be acquired by Canopius (itself a private Lloyd's (re)insurer that has Tower Group and Bregal Capital as strategic financiers).

The four recent deals mentioned above, highlight the increased interest from private equity and hedge funds who are looking to invest in a sector of the insurance industry that emerged out of the record year of claims in 2011, relatively well capitalised and well placed to take advantage of a general upturn in international pricing. US based P&C insurers and reinsurers are also seeking to diversify their underwriting and capital base as well as being attracted to the Lloyd's Central Fund,

which partially mutualises capital at a market level, thereby granting US based P&C insurers and reinsurers to the strong credit ratings assigned to Lloyd's.

b. Due Diligence

Given the unique structure of Lloyd's and of its regulations regarding ownership and control of entities within the Lloyd's market, any potential investor in a Lloyd's entity, irrespective of whether that entity is privately held or its stock is publicly traded, would be wise to conduct significant due diligence before making any investment.

Areas that may merit investigation include :

- Syndicate
  - : have all the underwriting years of account closed by reinsurance after 36 months, or are there any potential run-off issues?
  - : is the syndicate membership comprised entirely of corporate members owned by the managing agent, or are there individual Names who may seek to oppose any transfer of syndicate management?
  - : is the syndicate adequately reserved?
  - : are the syndicate accounts audited correctly in accordance with Lloyd's rules?
  - : are the syndicate funds held correctly in accordance with Lloyd's rules and are there any currency exchange liabilities caused by risks and deposits being in different currencies?

- managing agent : does the transaction require consent from Lloyd's and the FSA due to triggering "change of control" thresholds?

  : do the syndicates that the agent manages have their underwriting capital provided by the agent (or its parent) or by third parties, and will that capital continue to be available after the transaction closes?

  : if any syndicate(s) managed by the agent have members who are not owned by the agent (or its parent) has the managing agent complied with its contractual and fiduciary duties to those members under the applicable Lloyd's Agency Agreement?

  : will Lloyd's or the FSA seek to make the investor responsible for any acts or omissions of the current owners or controllers as a condition of granting consent?

  : has the managing agent complied with the applicable rules on the quantum and types of insurance risks it can underwrite?

c. Timetable – Accommodating Regulatory Consents

In addition to factoring due diligence into the anticipated timetable for the acquisition of a Lloyd's entity, the timetable will also need to accommodate the likely process for obtaining regulatory consents and the timing thereof. The likely timetable will depend in particular on whether the proposed transaction will involve the acquisition of an interest, or of control over, an entity that is only regulated by Lloyd's or whether that entity is also regulated by the Financial Services Authority.

- Corporate member : regulatory consent to establish or own a corporate member will be required from Lloyd's
- Syndicate : permission to establish or manage a Lloyd's syndicate will be required from Lloyd's
- Managing Agent : the establishment of a new managing agent or the acquisition of a controlling interest in a managing agent will require consent from both Lloyd's and the FSA

Timing of grant of regulatory approvals will vary depending on the relevant application(s) being made. To establish a new syndicate or managing agent will require detailed discussion with Lloyd's and the FSA and approval of business plans and resources as well as personnel. A basic "change of control" application to Lloyd's and/or the FSA should normally be granted or be the subject of a request for further information within 30 days although the FSA's statutory obligation is to respond to an application within 60 working days.

It is important to note that in considering whether a person is becoming a "Controller" or there is a "change of control" or "change of Controller" by reason of acquiring or reducing a shareholding or becoming a director of a regulated entity :

(a) the level at which control is exercised and for which regulated approval may be needed is for regulatory purposes considered not only at the level of the regulated entity itself but also at the level of any person or body which itself controls the regulated entity; hence, even if there is no change in controller at regulated entity level (because there is no change in shareholding or Board composition, for example) a change in Board or shareholder composition at the level of the parent company of the regulated entity can trigger a "change of

control" situation for which prior regulatory approval is required;

(b) "control", and thus the need for prior regulatory consent on any event that would cause a change in control, the level of control or the controller, is not limited to a consideration of only shareholdings, voting power and directorships at regulated entity level or at the level of parent of regulated entity; thus, if the exercise of voting power in the regulated entity or its parent is provided for by a shareholders' agreement between two or more shareholders who would not (by having, perhaps, less than 10% voting power each) individually be controllers, the fact of the arrangements under the shareholders' agreement being applicable to more than 10% of the voting power in aggregate may cause a control situation to exist, and any change in the shareholders' agreement which affected the possession or exercise of control could thus itself require prior regulatory approval;

(c) it is particularly important to identify any potential change of control or controller scenarios before they take effect; it is an offence under s.191 of the Financial Services & Markets Act 2000 for a person to fail to comply with the notification and consent requirements regarding changes of control or controller; in addition to the FSA having statutory enforcement powers to apply to Court for orders to unwind any unauthorized control or controller situations, miscreants may face fines and/or imprisonment.

Along with the accommodating regulatory approvals and consents as part of any acquisition process, a number of Lloyd's entities have operations in the US or the acquiror may have US operations which may trigger the requirement for anti-trust, US Hart-Scott-Rodino Act ("HSR" or the "Act") filings to be submitted.

HSR filings are relatively expensive and may lengthen the acquisition timeline. However, there are a number of exemptions and exceptions

that may be used by parties who have operations in the US to limit or even remove the scope or need for HSR filings.

Such HSR exemptions require careful analysis of the Act and of the US operations on a number of issues including the US operation's capital base, their revenue, their place of incorporation, the distribution channels for products and the structuring. It is prudent that where HSR issues appear relevant or there is the potential for HSR issues to arise in an acquisition of a Lloyd's (re)insurer, specialist advice is sought at the earliest available opportunity.

d. Transaction Structures

(i) **Buying share capital**

There area no legal peculiarities in buying the share capital of a Lloyd's entity as opposed to any other entity that is limited by shares. All the usual considerations as to :

- due diligence
- representations and warranties
- indemnities
- limitations of seller liability

will apply to the transaction; there are, however, some aspects of Lloyd's entities that may require additional consideration by any prospective purchaser of their share capital, including:

- the entity will be authorized and regulated by Lloyd's and/or the FSA; accordingly, acquisition of its share capital will likely require approval from Lloyd's and/or FSA and accordingly the acquisition will need to be made conditional on receipt of such approvals;
- in order for the entity to continue trading after acquisition by the purchaser, the entity will need to have sufficient resources

and regulatorily-authorized personnel to conduct controlled functions in the business; it is therefore imperative to ensure that sufficient assets and regulatorily-approved personnel will be available post-closing of the transaction;

- in view of the fundamental changes at Lloyd's since 1994 (as discussed in Section 1 above) it may well be the case that the entity has "legacy" issues; the entity may in the past have acted as both a managing agent and a members agent, or may have been controller of corporate members that it no longer owns; the entity may have acted as agent for third party capital providers on syndicates the entity once managed but no longer does; since acquisition of the share capital of the entity will expose purchasers economically to all legacy issues (for which English law may allow a limitation period of 12 years, or beyond, it is important to consider the "archaeology" of the target company and tailor representations, warranties and indemnities accordingly.

(ii) Buying the business and assets

Unlike a share acquisition which will bring with it economic exposure to target's history, an acquisition of the business and assets of a Lloyd's entity will be free of such issues (provided the sale and purchase contract is drafted correctly).

The transfer of the business and assets of a Lloyd's entity will require some careful thought as to which assets and liabilities are to be transferred to the purchaser, and which are to remain behind with the seller, but regulatory issues and the requirement for advance consents from Lloyd's and/or the FSA will be much reduced when compared to a share acquisition; for example:

- the transfer of assets and/or book(s) of business from a broker to another broker will not require consent from Lloyd's or the FSA;

- the transfer of a member's agency business to another authorized members' agency will not require the consent of Lloyd's or the FSA (but will require novation of the various agency agreements entered into by "Names"); but
- the transfer of a Lloyd's syndicate or the business of managing that syndicate will require Lloyd's and FSA consent.

Of critical importance in the acquisition of the business of a Lloyd's entity will be the ability to secure a transfer of existing contracts from the selling entity. These contracts will need to be checked to see whether assignment of the contract is permitted and in the case of a transfer of any Lloyd's agency contracts (whether between a Name and a managing agent for participation on a syndicate, or between a Name and a members' agent to appoint the members' agent) such transfer will need the consent of all the existing parties to the contract.

A key issue for the buyer on transferring contracts will be the issue of whether liability for past acts/omissions of the transferor under the contracts will be assumed by the buyer when the contract is assigned or novated to the buyer. This issue can either be dealt with by:

(a) apportioning liability under the sale and purchase agreement between buyer and seller so that seller indemnifies buyer for any claims regarding seller's breach of the contracts being assigned from seller to buyer, and/or

(b) by having the other contracting party or parties waive any claims against the buyer and confirm that their remedies lie against the seller

(iii) **Goodwill and non-compete covenants**

Whether buying a business and assets, or buying the share capital of a Lloyd's entity, the buyer will wish to secure the benefit of the goodwill attaching to the entity being purchased and (to the extent permitted by law) prevent the seller competing with the entity being purchased. In considering the extent of any non-compete covenants that might be

sought from the seller, there are a number of key issues that the buyer of a Lloyd's entity should consider:

- The enforceability of non-compete covenants will be subject to both anti-trust issues and to an English law concept of "reasonableness" so as to protect the buyer's legitimate interest in the goodwill being acquired, yet not operate as a restraint of trade or anti-competitive fetter on the seller;
- Since the Lloyd's market is (arguably) specialist and risks are brokered and underwriting decisions are taken in a limited geographic area, covenants that are too extensive in geographic scope or (if seller's ongoing business includes non-Lloyd's businesses) seek to exclude seller from business activities outside Lloyd's, run the risk of being held unenforceable; and
- As well as considering the non-compete covenants to be sought from seller, buyer should consider the enforceability of the non-compete covenants (if any) to which the employees to be taken on as part of the business or share acquisition are subject; Lloyd's being a market that is built on personal contact, the freedom of employees to take their contacts to a competitor will be a significant due diligence item for the buyer.

It is impossible to be precise as to the duration or extent of covenants that would be enforceable under English law since each covenant will be considered on its precise facts, but:

- A covenant given by a seller in a sale and purchase agreement for either the shares or business of a Lloyd's entity which precluded or restricted the seller from carrying on a competing business to that being sold for a non-compete period of up to five years may be enforceable;
- A similar covenant given by a selling shareholder or business proprietor (even if such person is taken on and employed by buyer as part of the transaction) should be enforceable if included in the sale and purchase agreement (and hence given

for good consideration) and if for a reduced period of between 12 and 24 months; and

- A non-compete covenant in an employment contract of an underwriter, broker or employee taken on and employed by buyer as part of the transaction will be the most difficult to enforce; the non-compete covenant will have to be reasonable and drafted so as to not prevent the employee doing other than contacting customers the employee had dealings with, disclosing confidential information or (for a senior employee only) working for a competitor; for a very senior employee, a lock-out covenant for up to 12 months may be enforceable but for a more junior employee of no particular risk to the business if he moved employer, any covenant which prevent him earning his living (as opposed to preventing him disclosing confidential information or soliciting clients) could potentially be unenforceable.

(iv) **Providing underwriting capital**

An alternative transaction structure that has become prevalent in the case of Lloyd's underwriting entities (such as a managing agent (or syndicate(s) it manages) or a corporate member) has been for investors to provide financial backing to these entities, essentially as regulatory capital, to enable the entity to meet the requisite solvency margin to accept premium income of a perhaps greater amount.

These arrangements for the provision of third party capital may, or may not, be combined with the capital provider taking a majority or minority equity stake in the relevant Lloyd's entity to whom the capital is made available. Given that traditional lenders such as banks may be reluctant to provide the financial backing that a Lloyd's insurer will need (particularly if the entity is a corporate member which will not be able to close its first underwriting year till month 36 and only then take any profits : see below) such financial support is increasingly necessary.

Examples of the types of financing structures in use include:

- providing letters of credit or bank guarantees as regulatory capital for Lloyd's corporate members
- quota share reinsurance arrangements to enable syndicates to automatically reinsure a proportion of business
- profit sharing arrangements whereby in return for the provision of assets eligible to form regulatory capital the provider receives a fee plus a profit commission linked to the underwriting result of the corporate member or syndicate concerned.

For the buyer of a Lloyd's entity, these financing structures raise issues such as:

- will the financing continue to be available or can it be withdrawn from the entity once buyer has acquired it?
- will the profits of the entity going forward be subject to the burden of sharing profits with the providers of such finance?
- even if the finance has terminated, if the cost of the finance was linked to the underwriting return of the entity in a given underwriting year, and that year has not yet reached closure at month 36 under Lloyd's 3 year accounting rules, will any eventual profits still have to shared with the provider of the (now withdrawn) finance?
- did the financing arrangement attach rights to the financier such as to raise "control" issues under Lloyd's and/or FSA rules and, if so, was controller consent obtained?
- if the finance was provided to a Lloyd's syndicate with individual Lloyd's members participating on that syndicate, was the arrangement arm's length and in accordance with the managing agent's fiduciary duties?

(v) **What if the target Lloyd's entity is listed on the London Stock Exchange?**

It is increasingly common for the larger Lloyd's underwriting entities and Lloyd's brokers to have obtained a public quotation for their shares and to be listed on the London Stock Exchange.

For a potential investor in, or acquirer of, a Lloyd's entity such listing brings a significant additional timing and regulatory impact to the transaction depending on the nature of the transaction involved :

- acquisition of a business or the share capital of a subsidiary company from a listed parent: under the rules of the United Kingdom Listing Authority ("UKLA") the seller may have to obtain prior shareholder approval and/or make a (more or less) detailed public announcement depending on the size of the transaction
- acquiring shares in the listed parent : share acquisitions will require to be notified to the company if the holding is more than 3% of the company's issued capital or increases an existing holding that is already above 3%; moreover, any acquisition of shares which took the acquirer beyond 30% would normally oblige the acquirer to launch a takeover offer for the entire company under the requirements of the UK Takeover Code.

As a result of these regulations, and the requirements to obtain regulatory consent from Lloyd's and/or the FSA, the acquisitions of Lloyd's entities where the seller has, or is part of a group that has, a quotation for its shares on the London Stock Exchange needs careful structural and timetable planning.

5. SPECIFIC REPRESENTATIONS AND WARRANTIES

In connection with the investment in, or acquisition of, the business or share capital of a Lloyd's entity, there are a number of core representations and warranties which (depending on the type of entity and whether the transaction involves investment in share capital or the

acquisition of a business and assets) are likely to be desirable for the buyer to obtain.

These include:

a. Syndicate Accounts and Agency Accounts

An investment in, or acquisition of, a managing agent will raise consideration of both the financial position of the managing agent, and of the syndicate(s) that it manages, especially if the syndicate(s) have external members who are not affiliated entities of the managing agent (or its owner(s)).

With regard to the financials of the managing agent, representations and warranties should include:

- that the audited financials comply with the UK Companies Act and with UK GAAP, have been prepared on a consistent basis with previous years' audited accounts, show a true and fair view of the financial position of the managing agent as at the accounting date to which the accounts are drawn up
- that the audited financials make full provision for, or disclose, all liabilities including for tax and that the results shown have not been affected by any exceptional or non-recurring items
- that the unaudited management accounts for the period since the accounts date have been prepared on the same basis as the audited accounts using the same accounting policies and show a materially accurate view of the assets and liabilities of the entity.

In the case of the syndicate, it has to be borne in mind that the syndicate financials are not the same as corporate financials in that the syndicate is not a legal entity and accordingly the usual accounting conventions will not apply to it; moreover, the syndicate accounts will be effectively the conglomeration of the individual financial trading accounts of all the syndicate members. Typical representations and warranties in relation to syndicate accounts would include:

- that the syndicate investments have been properly recorded, held in accordance with Lloyd's regulations and correctly valued in accordance with the policies and principles shown in the syndicate accounts
- that the expenses charged to syndicate participants are only those permitted by Lloyd's regulations
- that accounting records of the syndicate are up to date and have been maintained in accordance with Lloyd's regulations
- that the syndicate reserves as shown in the accounts are (at least) adequate to meet all liabilities known or which should be known
- that the syndicate accounts have been prepared in accordance with Lloyd's regulations and show a true and fair view of the financial position of the syndicate for all years of account shown

b. Agency Agreements: Agency and Fiduciary Duties

Of fundamental importance to any investor in, or acquiror of, a managing agent, syndicate or corporate member at Lloyd's is the manner in which the prescribed form Agency Agreements between syndicate members and the managing agent of the syndicate have (or have not) been complied with.

Under the prescribed form Agency Agreement the managing agent is appointed to act as agent for the syndicate member and on the member's behalf conduct underwriting at Lloyd's in the name of and for the account of the member; the member in turn endows the agent with all necessary authority to conduct the member's underwriting business at Lloyd's and bind the member by insurance risks underwritten on behalf of the syndicate members. The managing agent is therefore subject to a mixture of contractual duties expressed by the Agency Agreement and

duties implied by the nature of the agency appointment, including fiduciary duties towards the member making the appointment.

Usual representations and warranties directed at the managing agent's compliance with its duties under the Agency Agreement (and the same would to a large extent be true in the case of an investment in, or acquisition of, a members' agency at Lloyd's) would include:

- that the agent has entered into all prescribed Lloyd's Agency Agreements with each Lloyd's member for whom it acts
- that the agent has complied with all its express and implied duties to those Lloyd's members for whom it acts, both according to Lloyd's rules, the express terms of the Agency Agreement and according to the general law of agency including as to the holding of assets on behalf of the Lloyd's member and as to the conduct of the member's underwriting affairs at Lloyd's by the agent
- that in the conduct of the members' underwriting, the agent has not exceeded any applicable limits of authority, whether by accepting insurance risks of a different type than those set out in the syndicate's business plan, or by accepting premium in excess of the amount agreed with Lloyd's or as otherwise permitted by reference to the size of the member's regulatory deposits with Lloyd's
- that the agent has secured adequate and proper reinsurance for the risks accepted on behalf of the member.

c. Lloyd's Byelaws and Codes of Conduct

Central to any agreement for the acquisition of a Lloyd's entity will be confirmation that the entity has complied with all applicable regulatory requirements. As discussed in Section 2 above, in the case of some Lloyd's entities (particularly a managing agent) there will be applicable

Lloyd's and FSA regulatory requirements to be borne in mind. Typical regulatory compliance representations and warranties would include:

- that the entity is and at all material times has been duly registered with and approved by Lloyd's and, where applicable, the FSA to perform the functions which it now performs and has performed hitherto
- that the entity has conducted its business at all times in accordance with Lloyd's regulations and codes of conduct
- that the entity has entered into all agency agreements, undertakings, trust deeds and other documentation as from time to time required by Lloyd's regulations and has complied in full with all its obligations thereunder
- that the entity is not, and at no time has the entity been, in dispute with Lloyd's or any other regulatory body and that there have been and are not (whether present or pending) any proceedings brought against the entity by Lloyd's and so far as the directors/shareholders of the entity are aware there are no grounds on which any proceedings could be brought against the entity by Lloyd's
- that the entity meets and at all material times has met the required regulatory capital levels prescribed by Lloyd's
- full details have been disclosed of all reports and findings of Lloyd's concerning the entity (insofar as made available to the entity) including routine or periodic regulatory reports made by Lloyd's
- that all individuals conducting functions within the entity that are functions requiring the individual to be individually approved by Lloyd's have received and maintained all such approvals and have complied with Lloyd's rules in the discharge of such functions.

d. FSA Regulations

To the extent that the Lloyd's entity is also subject to direct regulatory requirements imposed by the Financial Services Authority (see Section 2 above), the type of representations and warranties as to regulatory compliance with regard to Lloyd's should also be sought as regards compliance with the Financial Services and Markets Act 2000 and the rules and guidance set out in the Financial Services Authority's handbook.

In addition, specific FSA compliance representations and warranties would include:

- that all books and records have been compiled and maintained in accordance with FSA requirements
- that all necessary client engagement letters and agreements have been entered into in accordance with FSA requirements
- that all client money has been held and invested in accordance with FSA requirements and in particular that it has been segregated as required from the assets and funds of the entity
- that the internal compliance function at the entity has been established and operated in accordance with FSA requirements
- that all necessary approvals have been obtained when required to all persons being or having been "controllers" of the entity and for any changes of 'control'.

e. Employees

In any transaction involving the acquisition of a Lloyd's entity by way of share, or business and asset, acquisition the employees, and compliance with applicable employment laws, will be of key importance for the buyer.

There are a number of issues to bear in mind when considering the employment aspects:

- in acquiring the share capital of a Lloyd's entity the acquiror will thereby have economic exposure to any employment law liabilities within the entity; even if the Lloyd's entity is not itself an employer (for example because a parent or affiliated company of the entity employs the work force but sub-contracts staff to the entity), it may have been an employer in the past and in any event will have legal liabilities to employees who are sub-contracted to it. Due diligence on employment issues will be of key importance to the buyer;
- it will be necessary for the Lloyd's entity, after acquisition by the buyer, to be able to satisfy Lloyd's and the FSA, if regulated by the FSA, that the entity has adequate resources to conduct its business post-closing of the transaction and in particular that the entity retains sufficient personnel who are "approved persons" and authorized to conduct controlled functions (such as being compliance officer, or handling client monies) within the entity;
- of potentially key significance may be the pension scheme entitlements of the employees and the purchaser will be concerned to ensure that the seller has funded the relevant scheme(s) to the necessary extent and that transferring employees will retain due entitlement to benefits.

f. Custody of Funds

Due to the agency relationships at Lloyd's, the underwriting income and expenditure (in the form of premiums received and claims paid out) of individual and corporate members of Lloyd's will be held and operated by their Lloyd's managing agent in trust accounts (known as Premium Trust Funds). The operation of trust fund accounts raises several issues for the acquirer of a Lloyd's entity:

- if the entity is a syndicate or a managing agent, will necessary control of the funds pass to the acquirer of the entity so that it can operate the trust accounts as the new proprietor of the business?
- to the extent that any fees or commissions due to the seller as previous agent can be drawn from trust fund monies, does the sale and purchase agreement provide for this?
- has the buyer secured the resignation of the seller and its nominees as trustees of the various trust funds and secured the appointment of the buyer and its nominees in their place so as to give the buyer control of the funds?
- do the representations and warranties in the sale and purchase agreement adequately protect the purchaser (especially on a share acquisition) against any breach of trust, misuse or misappropriation of the trust funds by the previous trustees appointed by seller?

CHAPTER TEN — M&A OPTIONS FOR MUTUAL LIFE INSURERS

WOLCOTT B. DUNHAM, JR. AND THOMAS M. KELLY[1]

1. M&A OPTIONS

Over the past two decades, many of the largest mutual life insurers in the U.S. opted to demutualize and reorganize themselves as stock companies, allowing them to participate more effectively in the consolidation that has swept the insurance industry since the 1990's. This Chapter discusses the options by which mutual life insurers can position themselves to participate in consolidation transactions, including full demutualization, formation of a mutual holding company and by the merger of mutuals.

a. Stand-Alone Demutualization

A mutual life insurer can demutualize and become the principal operating subsidiary of a new, publicly-traded holding company. This structure allows it to raise capital in the public equity markets. Furthermore, it can make acquisitions using stock of the stock holding company as the purchase consideration, or "acquisition currency," with the Target becoming a subsidiary of the stock holding company and a sister of the life insurer.

[1] Wolcott B. Dunham, Jr. is Of Counsel and Thomas M. Kelly is a partner in Debevoise & Plimpton LLP. Thomas M. Kelly is chair for the Americas of the firm's Insurance Industry Group. ©2012 Debevoise & Plimpton LLP. All rights reserved. All or parts of this Chapter have been, or may be, used in other materials published by the authors or their colleagues.

For example, Prudential Financial, Inc. has made several significant non-U.S. acquisitions during and after completing its demutualization in December 2001 and in 2010 announced its agreement to acquire Japanese insurance subsidiaries of American International Group, Inc. in a $4.8 billion transaction. MetLife, which demutualized in 2000, acquired Traveler's Life & Annuity and other insurance businesses from Citigroup in 2005 and in 2010 acquired American Life Insurance Company from American International Group, Inc. in a $16.2 billion transaction. The 2004 acquisitions by Manulife Financial Corp. of John Hancock Financial Services, Inc., and by AXA Financial, Inc. of The MONY Group Inc., each represent the combination of two demutualized companies in a stock merger.

A smaller company, Guarantee Mutual Life, demutualized in 1995/6 with an IPO and remained a public company until it was acquired by Jefferson-Pilot Corporation in 1999.

b. Sponsored Demutualization

A mutual life insurer can agree to be acquired in a transaction in which it becomes a wholly-owned subsidiary of the Acquiror, and the policyholders receive either cash or policy credits or Acquiror stock. A sponsored demutualization requires patience on the part of the Acquiror and cooperation of the mutual insurer's board of directors and Target's domestic state insurance regulator.

For example, Indianapolis Life Insurance Company agreed in September 2000 to be acquired in a sponsored demutualization by AmerUs Group Co. and the acquisition was completed in May 2001, and Provident Mutual Life Insurance Company agreed in August 2001 to be acquired in a sponsored demutualization by Nationwide Financial Services, Inc. and the acquisition was completed in October 2002. In February 2004, Security Mutual Life Insurance Company of New York announced that it had agreed to be acquired for cash by The Ohio National Life Insurance Company, the principal stock insurer subsidiary of a mutual holding company; however, the agreement was terminated after the

New York Insurance Department denied approval of the transaction on December 30, 2004.

In 2010, Security Benefit Corporation, a mutual holding company, agreed to demutualize and be acquired by Guggenheim Partners, LLC and a group of investors.

c. Acquisitions by Mutual Holding Companies and Their Subsidiaries

A mutual life insurer can reorganize in a mutual holding company structure. As with a demutualization, this structure allows it to raise capital in the public equity markets. Furthermore, it can make acquisitions using stock of the stock holding company as the purchase consideration, or "acquisition currency," with the Target becoming a subsidiary of the stock holding company and a sister of the life insurer. However, as discussed in this Chapter, the amount of stock that can be issued is limited, because the mutual holding company must at all times own at least a majority of the voting stock of the stock holding company.

For example, American Mutual Holding Company, formed in 1996, made several acquisitions, in one case issuing stock as acquisition currency. Reaching a practical limit on stock issuance, it subsequently demutualized in 2000, with AmerUs Group Co. as the resulting publicly-traded company. In November 2006, AmerUs Group Co. was acquired by Aviva plc. In 1999, Principal Mutual Holding Company made a large acquisition, issuing debt to acquire BT Australia, that was made possible by its mutual holding company structure. Subsequently, it completed a demutualization and listing of its stock in October 2001.

d. Mergers of Mutual Life Insurers

Two mutual companies can merge, to achieve economies of scale and to be able better to compete with other providers of financial services.

Since 1992, Connecticut Mutual merged with Massachusetts Mutual, New England Mutual merged with Metropolitan, Home Life merged with Phoenix Mutual Life, and Berkshire merged with Guardian Life.

2. CHANGES IN THE U.S. INDUSTRY

M&A considerations have been a driving force behind the pervasive change in the mutual sector of the U.S. life insurance industry during the past two decades.

a. Most Large Mutual Life Insurers Have Merged or Reorganized

Of the 25 largest mutual life insurers as of the end of 1990, only six remain mutual life insurers today. Only four of these companies have not been party to a merger or reorganization. However, several large mutuals remain resolutely mutual.

b. Need for Capital and Consolidation Drive These Transactions

Demutualization was driven initially by the need for capital and, by the mid-1990s, the consolidation sweeping the life insurance industry.

Beginning in the early 1990s, risk-based capital requirements put a new focus on capital. Rating agencies demand strong capital positions (though they demand strong earnings as well). Demutualization gave mutual insurers access to capital, whether to meet rating agency criteria or to make acquisitions, as acquisitions and consolidations require the ability to access capital when the need arises.

Mutual insurers cannot issue capital stock as acquisition currency but must pay cash (or issue notes). A company acquired by a mutual life insurer can only be a subsidiary of the life insurer, so that:

- A sizeable acquisition would impose significant risk-based capital requirements on the life insurer, since the risk factor for non-insurer subsidiaries and affiliates is currently 30% of statutory statement value (the risk factor for an investment in a subsidiary life insurer is that subsidiary's authorized control level risk-based capital).
- Statutory accounting practices and National Association of Insurance Commissioners Securities Valuation Office valuation rules applicable to insurers require that goodwill (the excess of cost over underlying "net asset value" of the acquired company) of all subsidiaries exceeding 10% of capital and surplus must be written off immediately and remaining goodwill must be written off over a period not in excess of ten years.
- In most states, there are limits on the amount a life insurer may invest in subsidiaries, often with a less restrictive limit for subsidiaries that are life insurers.

For these reasons, a mutual life insurer is handicapped in making sizeable acquisitions, particularly in acquiring companies that are not life insurers.

c. Legislation Offers Mutual Insurers Several Forms of Reorganization

Statutes enacted in the 1990s authorize alternatives to the traditional demutualization structure. A company should think creatively in considering its options, while keeping in mind the practicalities of the capital markets, the expectations of its constituencies, and legislation and regulatory hurdles. By doing so, a company can draw from the experience of four major mergers, at least six companies that have demutualized since 1992 and another seven substantial companies that have adopted mutual holding company plans (several of which have gone on to demutualize the mutual holding company).

3. TWO KINDS OF REORGANIZATIONS OF MUTUAL LIFE INSURERS

A mutual life insurer considering reorganization will consider whether to pursue complete demutualization or the formation of a mutual holding company. Each results in the mutual life insurer becoming a stock company. The two kinds of reorganization differ in how they affect the policyholders, as illustrated by the chart on the next pages, and the mutual holding company structure is illustrated by the diagram in Section 5.b of this Chapter:

Mutual Life Insurer Policyholder Rights Before Any Reorganization and After a Mutual Holding Company Reorganization or a Demutualization

	Right	*Before*	*After MHC Reorganization*	*After Demutualization*
Policy Rights	Right to receive, as policyholder, policy guarantees	Policy benefits and guarantees are obligations of mutual life insurer.	No change: Policyholder continues to be a policyholder in the same life insurer whose corporate existence continues uninterrupted, but the insurer would now be a stock life insurer with the same or a different name. The conversion will not, in any way, increase premiums or reduce policy benefits, values, guarantees or other policy obligations. All policy obligations remain obligations of the converted life insurer.	No change: Same as MHC reorganization
	Dividend rights	Some policies pay dividends that are based on the mutual life insurer's	Dividend-paying policies will continue to pay dividends, based on	Same as MHC reorganization

	Right	*Before*	*After MHC Reorganization*	*After Demutualization*
		experience (investment, mortality and expense experience). Dividends may increase or decrease as experience changes.	the converted life insurer's experience (investment, mortality and expense experience). As before, dividends may increase or decrease as experience changes. For *individual* policies with *experience-based* dividends, these dividends could have the protection of some type of mechanism such as a "closed block." In a closed block, assets are allocated to the closed block that produce cash flows, together with anticipated revenues, expected to be sufficient to support these policies including paying claims, certain expenses and taxes, and *continuation of current dividend scales, if the experience underlying such dividend scales continues, and for appropriate adjustments in dividend scales if the experience changes.*	
Member Interests	Voting in election of directors	One vote per member in election of directors of the mutual life insurer under most states'	Moves to the mutual holding company: one vote per member in election of directors of mutual holding	Member voting rights are extinguished in exchange for consideration. Voting rights are

	Right	*Before*	*After MHC Reorganization*	*After Demutualization*
		laws.	company, the ultimate parent of the converted life insurer. Through their voting control of the mutual holding company (which always owns a majority of voting stock of stock holding company), the members continue to control the life insurer.	held by stockholders.
	Liquidation rights	Under most states' laws, policyholder claims have priority over claims of most creditors. In addition, policyholders (as members) share in any assets left after payment of all liabilities.	Upon liquidation of the converted life insurer, policyholders have same priority as before conversion. In addition, assets of the mutual holding company are available to pay policyholder claims. Policyholders (as members of mutual holding company) also share upon mutual holding company liquidation in any assets of the mutual holding company left after payment of its liabilities.	Members' liquidation rights are extinguished in exchange for consideration. Stockholders share in any assets left after payment of all liabilities.
	Conversion to a stock corporation	Mutual life insurer could convert to a stock life insurer through either demutualization or mutual holding company structure.	Demutualization is not precluded. Mutual holding company could convert to a stock corporation through a demutualization at some future date (and its members	N.A.

Right	Before	After MHC Reorganization	After Demutualization
		could participate in any related distribution) if it were determined that such an alternative was appropriate.	

4. DEMUTUALIZATION OF LIFE INSURERS

In a demutualization, as the table above illustrates, the insurer becomes a stock company, membership rights are extinguished, and policyholders receive stock, policy credits or cash in exchange for membership rights but for no other consideration. In a sponsored demutualization (where the converting insurer becomes a subsidiary of the Acquiror), the consideration could be stock of the Acquiror, or cash distributed by the converting insurer that is replenished by a capital infusion from the new parent.

a. Mandatory IPO

With the exception of the sponsored demutualization of Provident Mutual Life Insurance Company in 2002, in which policyholders received shares of Nationwide Financial Services, Inc., all of the major U.S. demutualizations completed since 1992 have been conditioned upon the completion, on the effective date of the demutualization, of an initial public offering (an "IPO") of the newly-formed parent of the demutualized insurer. Such an IPO serves several purposes. An IPO following a road show places stock in both institutional and retail hands. Analysts for managing underwriters generally follow the stock of companies whose offerings they have managed, and analysts' reports are useful in establishing a good trading market. Thus, by creating a liquid trading market, the IPO gives liquidity to policyholders receiving stock.

Equally important, some policyholders will receive cash or policy credits instead of stock (as discussed below), and use of the IPO price (or the greater of the IPO price and an average trading price during some early period of trading, as in the 2000 John Hancock demutualization) to translate notional share allocations into dollars allows that translation to be based on the marketplace. Thus, the marketplace determines this valuation of the company. The board of directors need not set a value, and the state insurance regulator need not bless a value.

The third and sixth largest U.S. IPOs in 2000 were the demutualization-related IPOs of MetLife, Inc. and John Hancock Financial Services, Inc. The Principal Financial Group, Inc., Phoenix Companies, Inc., Anthem, Inc. and Prudential Financial, Inc. IPOs in 2001 accounted for $8.6 billion in offering value.

b. Sponsored Demutualization

In a sponsored demutualization, a purchaser or investor acquires, at the time of the demutualization, a significant, or even controlling, block of stock, or all of the stock, of the demutualized insurer and, as compensation for their membership interests, the policyholders receive either a minority of the stock or receive cash. Thus, a sponsored demutualization is a method for the insurer to raise new capital from the investor institution. This approach could be used where the public capital markets might not value the insurer's stock as favorably as the company might wish, or where an affiliation with a larger institution would add strength to the insurer. Examples of U.S. sponsored demutualizations include Provident Mutual's October 2002 acquisition by Nationwide Financial Services, and AXA's 1992 investment of $1 billion in The Equitable Life Assurance Society of the United States, an investment which was made while The Equitable was a mutual and which converted into approximately half the shares of The Equitable's new parent company.

A sponsored demutualization generally requires a departure from the approach of letting the marketplace value the converting insurer. Most

bidders wish to acquire 100 percent of the voting stock, and wish to acquire it in a single step at the completion of the demutualization. A mandatory IPO would place voting stock in the hands of numerous stockholders. For this reason, an IPO is not part of a sponsored demutualization. Instead of reliance on the markets to value the company, a sponsored demutualization may require a judgment that the exchange of consideration is, in the aggregate, fair to policyholders.

Thus, the board of directors would likely receive a fairness opinion from the company's financial advisors to the effect that the exchange of consideration is, in the aggregate, fair to policyholders from a financial point of view. That opinion would likely be reproduced in the policyholder information statement that is sent to policyholders to solicit their vote. The fairness opinion would likely be reviewed by the state insurance regulator, which might itself engage financial advisors.

The rendering of such a fairness opinion involves an examination of indicia of the value of the mutual life insurer and also a review of the value of the consideration policyholders are receiving. In the 1989 Royal-Maccabees sponsored demutualization, policyholders received cash, which is easy to value. In the 2002 Provident-Nationwide sponsored demutualization, policyholders had the right to elect to receive stock of Nationwide Financial. The parties therefore negotiated a mechanism for adjusting the number of shares issued in the aggregate, based on the trading price of the Acquiror's stock.

Other distinctive features of a sponsored demutualization are the Acquiror's desire for deal protection, the possibility that economic terms of the demutualization plan could change if the acquisition agreement is signed before the Target mutual company embarks on the lengthy process of reviewing its plan with state insurance regulators and the need for cooperation between the Acquiror and seller through that regulatory process. The Provident-Nationwide agreement contained terms addressing each of these issues, including "break-up fee" provisions customary in public company mergers and a price adjustment formula for changes in closed block funding.

c. Closed Block

Because a demutualization introduces stockholders and therefore may be perceived as introducing a potentially competing claim on the earnings of the insurer, a closed block has typically been used to protect individual participating policyholders' dividend expectations. Assets are allocated to the closed block that produce cash flows that, together with anticipated revenues, are expected to be sufficient to support obligations under the policies in the block (typically, individual policies with experience-based dividends), including paying claims, certain expenses and taxes, and continuation of current dividend scales, if the experience underlying such dividend scales continues, and for appropriate adjustments in dividend scales if the experience changes.[2]

The funding of the closed block is of great interest to an Acquiror in a sponsored demutualization, because an overfunding would reduce the value of the company to its new shareholder.

d. Actuarial Calculation of "Equity Shares"

In the United States, it has become customary to begin by determining the total number of shares to be notionally allocated to policyholders eligible under the state demutualization law to receive consideration — typically the holders of policies in force on the board adoption date, on the plan effective date, or on both dates.

A portion of those shares, typically 10% to 20%, is allocated on a per capita basis, a "fixed component" of a specified number of shares to each eligible policyholder. The fixed component is thought of as compensation for a policyholder's giving up the vote in the election of

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2 *See* Actuarial Standard of Practice No. 33, *Actuarial Responsibilities with Respect to Closed Blocks in Mutual Life Insurance Company Conversions*, adopted January 1999.

directors. Under the laws of most states, each policyholder has one vote, regardless of the size or number of policies he or she owns.

The rest of the shares are notionally allocated among eligible policies *pro rata* in proportion to their contribution to the company's surplus, most often both historical contribution to surplus and projected future contribution to surplus. (The historic contribution of all in-force policies to surplus is typically less than the company's aggregate surplus, because for most companies some of the surplus, the "orphan surplus," was contributed decades ago by policies that have long since matured.) Classes of policies that have negative contribution to surplus typically have their contributions set to zero. This calculation results in the variable component.[3]

In a U.S.-style allocation, the calculation of allocations is made *in proportion* to relative contribution of each class of policies to surplus, historic only or historic and prospective, requiring months of fact gathering from company archives. The allocation algorithms are then applied to data currently maintained on computer systems in the ordinary course of the company's business, *e.g.*, cash value, face amount and duration of each policy. A non-U.S. style allocation, such as the allocation used by Norwich Union (U.K.) or Australian Mutual Provident Society, uses much simpler algorithms.

The U.S. approach to allocation has been criticized as unnecessarily complex and expensive, multiplying transaction costs at the expense of policyholders, for whom any distribution is a windfall. There are

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[3] For the basic actuarial principles underlying the allocation of consideration in a demutualization, see *Report of the Task Force of the Society of Actuaries on Mutual Life Insurance Company Conversion*, 39 Transactions of Society of Actuaries 295 (1987), republished as *Conversion of Mutual Life Insurance Companies: Final Report of Society of Actuaries*, 7 J. of Ins. Reg. 213 (1988), and reprinted also in Dunham (chairman), *Demutualization of Life Insurers* (Practising Law Institute Course Handbook 648, 1993), and Actuarial Standard of Practice No. 37, *Allocation of Policyholder Consideration in Mutual Life Insurance Company Demutualizations,* adopted June 2000.

streamlining approaches that could be used that would nevertheless be fair and equitable. For example, in the 2010 sponsored demutualization of Security Benefit Corporation all members received the same amount of consideration, approximately $100 in cash or policy credits.

e. Distribution of Consideration

A particular policyholder's notional allocation will consist of a fixed component (one fixed component per policyholder) and the aggregate of the variable components for all the policies the policyholder owns. That notional allocation is then translated into actual shares for most policyholders.

However, Individual Retirement Arrangements ("IRAs") and tax-sheltered annuities ("TSAs") typically do not receive actual shares but rather have their allocations translated into policy credits — credits to policy account values — to avoid any question as to whether receipt of stock would disqualify the IRA or TSA from enjoying its favorable tax treatment.

In addition, the Principal and Provident reorganization plans allowed policy credits on an optional basis to certain ERISA-plan customers for whom the receipt of stock or cash would have been problematic under ERISA.

Furthermore, those who would receive very small holdings of stock are often cashed out. Both for policy credits and for cashouts, the notional allocation of shares is typically translated into dollars at the IPO price.

In a sponsored demutualization, depending on the structure, tax laws can limit the percentage of consideration that can be paid in a form other than stock.

f. Dealing with Small Allocations of Shares

The allocation method described above has sometimes resulted in allocations of small numbers of shares to large numbers of policyholders. For example, The Equitable's fixed component was three shares. The IPO price was $9 per share. Thus, there were hundreds of thousands of policyholders who received compensation worth $27. Distributing three shares does not give significant value to the policyholder, particularly where a sale of the shares on the New York Stock Exchange would incur minimum brokerage commissions of more than $27. And many policyholders do not know a stock broker. From the company's point of view, it is very expensive to maintain large numbers of stockholder accounts.

For all of these reasons, plans of demutualization provide for cashing out policyholders who are allocated fewer than a specified number of shares. Regulators are concerned that a cashout deprives the policyholder of the post-IPO increase in the value of the shares. As a result, plans sometimes give a choice of cash or stock to policyholders who are allocated a small number of shares; those who do not express a choice are sometimes given cash.

As a further method of reducing the number of stockholders, companies have offered a commission-free sales and round-up program. A "round lot" for trading in U.S. markets is 100 shares. Policyholders who received fewer than 100 shares are given the opportunity, perhaps six months or a year after the demutualization, during an announced period of time, to either sell their holdings at the market price, or purchase additional shares at the market price to bring their holdings up to 100 shares. The company bears all brokerage commissions and administrative costs. The bank that acts as transfer agent also administers the program. Stockholders' orders are placed in a queue. Sell orders and buy orders are offset against each other at current market prices, and to carry out the net difference the bank places buy or sell orders in the market through a single, identified stock broker. To facilitate participation in the program, policyholders are encouraged to

receive their shares in uncertificated form, without the issue of stock certificates. These programs have been successful in reducing the number of stockholders. Nonetheless, for a company with millions of policyholders — some of them companies that grew early in this century by selling numerous small policies of industrial life insurance — addressing the number of stockholders remains a significant issue.

The demutualization of Metropolitan Life Insurance Company, completed in April 2000, was the first to address the large number of stockholders by establishing a policyholder trust. Metropolitan had over 10 million eligible policyholders. To reduce the cost of administering over 10 million shareholder accounts, its plan of demutualization provided that almost all eligible policyholders could elect to receive their compensation in cash (based on the IPO price) and that most policyholders who made no such election would receive their shares through their being deposited in a policyholder trust (the "Trust") for their benefit. Initially, all shares were deposited into the Trust and all policyholders receiving shares became beneficiaries of the Trust. Beginning shortly after the effective date of the Plan, beneficiaries of the Trust may begin selling their shares from the Trust through the Purchase and Sale Program, at market prices, without payment of any brokerage commission. Beginning on the first anniversary of the effective date of the Plan, a beneficiary of the Trust could withdraw all (but not less than all) of his or her shares. The main benefit for keeping shares in the Trust is the availability of the Purchase and Sale Program. Subject to the restrictions set forth in the Purchase and Sale Program Procedures, beneficiaries of the Trust are permitted to sell their shares held in the Trust on a commission-free basis for the duration of the Trust. In addition, beneficiaries holding fewer than 1,000 shares are permitted to purchase additional shares to be held in the Trust, also on a commission-free basis. Also, the Trust enables MetLife to save costs of mailing annual reports and proxy statements to Trust beneficiaries unless a contested matter or major corporate matter is presented to shareholders, in which event their vote is to be solicited. The prospect of these savings was intended to support a higher IPO price.

g. Subscription Rights Demutualization

When it is said that a mutual insurer will, at or after its reorganization, offer subscription rights to its members to buy stock, it is important to be clear about the type of subscription rights that are meant.

For example, the laws in several states authorize a demutualization in which policyholders receive, in consideration for the extinguishment of their membership interests, subscription rights to purchase stock in the converted enterprise at the public offering price or a discount. Unsubscribed shares may be offered first to employees and then to the public. Non-subscribing policyholders do not receive any other distribution. This method of demutualization, first used in demutualization of mutual thrifts, maximizes the capital raised, because no shares or cash are distributed to policyholders. Litigation was brought challenging the already-completed conversion under such a law of one group of mutual property/casualty companies based on its particular facts.[4] A separate action was also brought in state court by an individual who was both an Old Guard policyholder and the chairman of a rebuffed bidder seeking to buy the Old Guard companies through a different method of demutualization. Several other subscription rights demutualizations of property/casualty insurers have been completed.

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[4] Crandall v. Alderfer, No. 97-757 (E.D. Pa., complaint filed Feb. 7, 1997) (purported class action challenging on constitutional and statutory grounds the conversion of three mutual property/casualty insurers under a plan making them subsidiaries of Old Guard Group, Inc.; defendants' motion for summary judgment granted March 5, 1999 as to claims alleging private defendants were "state actors" under 42 U.S.C. § 1983. 1999 U.S. Dist. LEXIS 2422).

5. FORMING A MUTUAL HOLDING COMPANY

a. Mutual Holding Company Laws Utilized Since 1995

Beginning in 1995, the mutual holding company structure became a focus of intense interest among mutual insurers, especially small and medium size mutual life insurers. A mutual holding company allows a company to raise permanent equity capital by issuing stock and to use stock as acquisition currency. The first mutual insurer to use the mutual holding company structure was American Mutual Life Insurance Company (renamed AmerUs Life Insurance Company) in 1996. Interestingly, AmerUs, the first mutual life insurer to reorganize using a mutual holding company structure, completed the demutualization of its mutual holding company in September 2000.

At least twenty-six life insurance companies have completed reorganization in a mutual holding company structure, including: AmerUs Life (formerly American Mutual), General American Life, Acacia Life, Pacific Life (formerly Pacific Mutual), Principal Life (formerly Principal Mutual), Ameritas Life, Ohio National Life, Minnesota Life (formerly Minnesota Mutual), Union Central Life Insurance Company, Security Benefit Life, National Life of Vermont, Security Financial Life (formerly Security Mutual Life (Nebraska)), American Republic Insurance Company, Woodmen Accident and Life, Mutual Trust Life, Trustmark Insurance, National Travelers Life, The State Life Insurance Company, Western and Southern Life, American United Life, Lincoln Mutual Life, Lafayette Life, The Baltimore Life Insurance Company, United Heritage Life, Pioneer Mutual Life, and World Insurance Company. The Union Central Life reorganization into a mutual holding company structure was done in connection with the 2006 merger of its mutual holding company with Ameritas Acacia Mutual Insurance Holding Company, itself the product of the 1999 merger of the mutual holding companies formed in the reorganizations of Acacia Life and Ameritas Life. The combined entity operates as

UNIFI Mutual Holding Company. Property/casualty companies have also adopted mutual holding company plans.

Mutual holding company laws have been enacted in the District of Columbia and a majority of the states, including California, Florida, and Illinois. Notable exceptions include New York (where the Legislature recessed in July 1998 without enacting a much-debated pending bill and where a bill was reintroduced in 1999 but not enacted) and New Jersey (where the only mutual life insurer, Prudential, has demutualized). The Gramm-Leach-Bliley Act of 1999 authorizes redomestication as part of a reorganization of a mutual insurer in a mutual holding company structure.[5]

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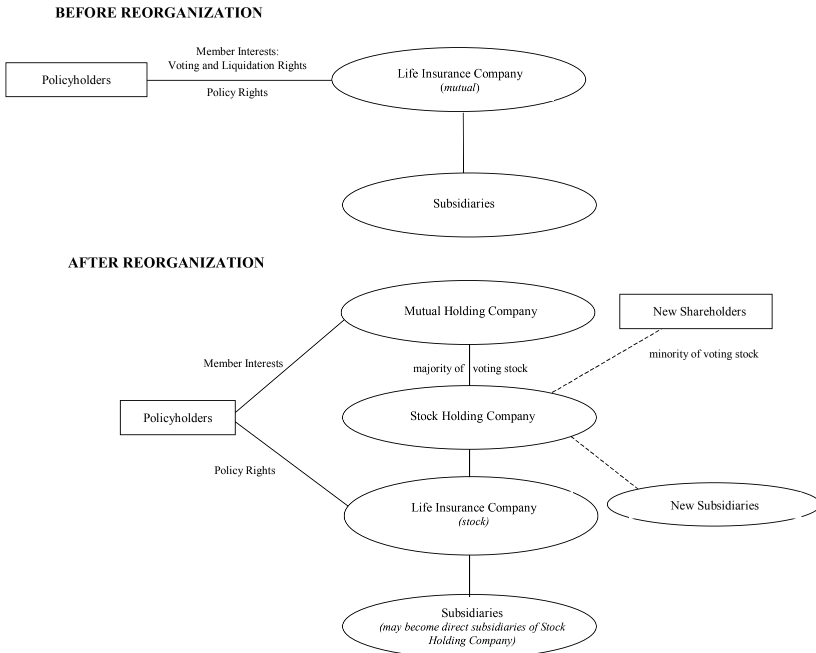
[5] Gramm-Leach-Bliley Act §§ 311-316.

b. The Mutual Holding Company Structure



c. Major Elements of Reorganization as an MHC

The life insurer reorganizes, separating the membership interest from the insurance contract. The insurer becomes a stock company that is a direct or indirect subsidiary of a mutual holding company ("MHC"). Policy guarantees, and payment of policy dividends, remain with the life insurer (now a stock company). Membership interests (primarily the right to vote for directors and to share in surplus in liquidation) become interests in the MHC. The MHC is required to hold at all times, directly or indirectly, at least a majority of the voting power of the converted insurer.

Inclusion in the structure of a stock holding company ("SHC") gives greater capital-markets flexibility, because it can issue debt and

contribute the proceeds to the insurer as statutory surplus and permits acquisitions of subsidiaries of the SHC and sisters of the insurer, freeing the acquisitions from the constraints described above that are now imposed on acquisitions by a life insurer. The SHC has either two classes of stock (as in AmerUs) or one class (as in Pacific Life), but an MHC must always hold stock carrying a majority of the votes.

The MHC is not authorized to issue shares. Its members have the right to elect its board of directors and would have the right to any distribution of residual net assets if it liquidated while solvent. The initial members would be the policyholders of the converting mutual life insurer, who would cease to be members of the insurer and would become members of the MHC. As the converted insurer continues to write policies and contracts, the new policyholders would become members of the MHC.

The structure would not preclude a subsequent demutualization of the MHC in which its members could become shareholders.

After reorganization, the life insurer would continue to pay dividends on its par policies in force at the time of the reorganization. Prior to selling stock to the public or as its policyholder base changes to predominantly non-par, the company could establish a closed block for dividend purposes as one way of protecting the reasonable dividend expectations of holders of individual dividend-paying policies.

The insurer could pay dividends to its shareholder, the SHC, which would, in turn, pay dividends to its shareholders, the MHC and the public shareholders. The MHC might reinvest the dividends in SHC stock or use the dividends in other ways to benefit members. In its May, 1998 order approving Principal Mutual's MHC conversion, the Iowa Commissioner of Insurance imposed specific requirements to assure that any "excess accumulated earnings" of the MHC would "inure to the exclusive benefit" of policyholder members.

This topic is affected by views of SEC staff in granting a no-action letter, to obtain the SEC staff's agreement that the membership in the MHC will not be a separate security. If membership interests were

securities, then even traditional insurance policies would need to be sold by prospectus, and all producers would need broker-dealer licenses.

American Mutual's no-action letter was issued after many months on June 13, 1996, and no-action letters were also obtained by General American (Feb. 20, 1997), Pacific Mutual (April 17, 1997) and Acacia (June 27, 1997). As a condition of granting the American Mutual no-action letter, the SEC staff required that the mutual holding company not pay dividends to its members except as directed or approved by the domestic state insurance regulator or pursuant to voluntary dissolution or liquidation approved by the state insurance regulator.

Based on representations about Iowa law made by American Mutual, the SEC staff also noted that the mutual "Holding Company will be subject to regulation by the Iowa Commissioner of Insurance at a level equal to that of an Iowa domestic insurance company (*e.g.*, the Holding Company's ability to engage in non-insurance related activities is limited to the same extent as an Iowa domestic insurance company and the Holding Company may not merge with, be acquired by or acquire another entity without approval of the Iowa Insurance Commissioner and the Iowa Attorney General)."

A mutual holding company reorganization is simpler and can be faster than traditional demutualization. There is no mandatory initial public offering and no actuarial calculation of policyholder "equity shares." Consumer advocates have criticized the mutual holding company concept, urging that mutual companies should remain mutual or demutualize. Mutual holding company reorganizations have received considerable regulatory attention. For example, the National Association of Insurance Commissioners issued a "white paper" on mutual holding companies dated December 7, 1998 titled "Mutual Insurance Holding Company Reorganizations."

One company, AmerUs, has not only reorganized in a mutual holding company structure, but also used the structure to raise capital through an IPO and other capital-markets transactions, and used the stock-

holding-company stock as acquisition currency. The demutualization of AmerUs mutual holding company was completed September 2000.

6. MERGERS OF MUTUAL LIFE INSURERS

For some companies, a merger of mutuals can address issues of capital and competitive position while preserving the mutual form. A merger can bring economies of scale.

A merger must be approved by both boards of directors and must receive the approval of voting policyholders and the approval of the state insurance regulators in the states of domicile of both merger partners.

a. Dividend Principles

One of the most critical elements of the merger from the point of view of fairness to policyholders (and approval by state insurance regulators) is the construction of dividend principles for the merged company. How can the reasonable dividend expectations of the two sets of pre-merger policyholders be protected after the merger, given differences between the two companies in their investment, mortality and expense experience?

In demutualizations since the early 1990s, the closed block has been the solution. However, a demutualization introduces not simply more mutual members but stockholders, and a closed block is one way of protecting participating policyholders' dividend expectations. However, a closed block is not appropriate in a merger, where no stockholders are introduced. In mutual life mergers since 1992, a different mechanism has been used. The merger agreements contain a dividend policy contemplating three groups of policyholders, within which there would be separate dividend classes: pre-merger policyholders of the survivor, pre-merger policyholders of the non-survivor and post-merger new policyholders. For a period of, say, ten years following the merger,

investment, mortality and expense experience is tracked separately and reflected in dividends. The appropriate classes of business are combined for dividend purposes at the end of the ten-year period.

A related issue is how to allocate the expense savings of the merger between the different classes of policyholders. In the Massachusetts Mutual/Connecticut Mutual merger transaction, for example, expense savings were allocated for dividend purposes 60 percent to pre-merger Massachusetts Mutual policyholders and 40 percent to pre-merger Connecticut Mutual policyholders, *i.e.*, roughly in proportion to the pre-merger sizes of the companies.

b. Structural Options

The parties must agree on the structure of the merger, including the identity of the merger partner that will, as a matter of corporation law, be the survivor. (This question is separate from the question of composition of the board and the identity of senior officers.)

The merger must be authorized by statute in the state of domicile of each merger partner: both the insurance code and the corporation law may be applicable in a particular state, and one must analyze how those statutes interrelate. It is generally necessary that each merger partner be licensed in the state of domicile of the other merger partner; some merger laws impose this requirement, and continued writing in both states adds a practical reason for such licensing.

c. Social Issues

The parties must agree at an early stage on the composition of the board of directors of the survivor, drawn from the boards of the two constituent companies, and the structure of senior management. The merger agreement may spell out with great specificity how senior management and the boards of directors of the two companies will be integrated.

d. Federal Securities Law Issues

Generally, voting on a merger proposal by holders of SEC-registered variable life insurance policies and annuity contracts should not require compliance with the SEC proxy rules under Section 14 of the Securities Exchange Act of 1934 and Section 20 of the Investment Company Act of 1940 (the "1940 Act"), because the voting rights arise from the insurance aspects of the variable product, not the separate account or investment fund aspect, and voting rights would be unchanged by the merger.

A change of control of an investment advisor is deemed to terminate its advisory contracts, requiring the solicitation of mutual fund stockholders and private investment advisory clients of the investment advisor for their approval of the change of control. What constitutes a change of control is a fact-based determination, but it is likely that the merger will be deemed a change of control at least as to the non-surviving company.

Existing SEC exemptive orders should be reviewed. The registration statements for the non-surviving company's variable products must be re-filed by the surviving company because it is the new issuer.

With respect to separate accounts, the parties will wish to consider a number of issues on which they might seek no-action assurance from the SEC staff.

e. Federal Income Tax Considerations

It will be necessary to obtain either opinions of counsel or an IRS private letter ruling to the effect that the merger transaction is tax-free to policyholders and the companies. It may also be necessary or desirable to obtain opinions or rulings regarding some of the ancillary tax consequences of the transactions. These include rulings or opinions confirming that insurance contracts issued by the merging company will not be treated as reissued or exchanged for new contracts as a result of

the merger, so that the contracts will not lose favorable treatment under various "grandfathering" provisions that have insulated previously issued policies from legislative changes in the taxation of life insurance contracts (for example, the enactment of Internal Revenue Code Section 7702, which defines "life insurance" for tax purposes). Rulings or opinions relating to the effect of the merger on the tax balance sheet of the Acquiror, including the carry forward of tax attributes and balances and the DAC tax implications of merging the companies and other issues relating to company tax computations for the year of the merger, may also be necessary or desirable.

Whether an IRS ruling can or should be obtained will depend upon the exact nature and structure of the transaction and timing and other considerations.

f. Antitrust

A filing will be required under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended.[6] Filing requirements may also be triggered, both as to the merging companies and their subsidiaries, under the "market share" provisions of various states' insurance holding company acts.[7]

g. Department of Labor/ERISA

The transaction will need to be analyzed from an ERISA perspective to determine whether any "prohibited transaction" is involved and, if so, whether an existing exemption is available or whether an individual administrative exemption should be sought from the U.S. Department of Labor. Also, consideration should be given to whether independent

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6 For a discussion of this filing requirement, see Chapter Five.

7 For a discussion of this filing requirement, see Section 2.b(2) of Chapter Four.

fiduciaries should be engaged to represent any employee benefit plans maintained for the benefit of the merging companies' own employees.

h. Third Party Consents

Agreements of both merging companies with third parties will need to be reviewed to identify any necessary consents to the merger, which could be deemed a change of control. For example, reinsurance agreements may allow the reinsurer to terminate the agreement (as to new business) upon a change in control of the ceding company. Therefore, it will be necessary to confirm that the reinsurance ceded by both mutual insurers and by their subsidiaries will be unaffected by the merger.

i. Other Insurance Regulatory Filings and Approvals

Depending on the structure of the merger and the particular state insurance holding company statutes involved, change of control applications may need to be filed with the domestic state insurance regulators of the insurance subsidiaries of at least the non-surviving company (and state insurance regulators of states in which the subsidiary may be "commercially domiciled," *e.g.*, California). If the non-surviving merger partner is licensed to do an insurance business in California, the consent of the California Commissioner of Insurance may also be required in order to avoid the entry of a conservation order issued with respect to the non-surviving merger partner. The laws of relevant foreign jurisdictions would need to be reviewed to identify any necessary filings and approvals.

Once the desired integration of products and agency forces is outlined on the business level, it will be necessary on a 50-state basis to coordinate changes in policy form filings and agent appointments and, possibly, changes in the licensing of the surviving company (to reflect a name change or a change in licensing authority). This is a large task, but there is now precedent both in mutual mergers and in the major life

insurer demutualizations for coordinated and timely action by the non-domestic state insurance regulators to allow the company to continue business without interruption immediately after the closing.

j. Building the Record for the Board of Directors: Opinions of Advisors

Each merging company will retain legal, financial and actuarial advisors. Both the financial and the actuarial advisors will render opinions as to the fairness of the transaction to policyholders. The financial advisors' opinions will rely heavily on both the work of the actuaries and the financial forecasts for the merged company. The actuarial opinions will focus heavily on the fairness of the dividend policy adopted and on the expectation that as a result of expense savings, dividends will be higher than they otherwise would have been.

Also, if either of the parties has "Harris Trust" type contracts outstanding so that general account assets may to some extent be "plan assets" subject to ERISA, it may be advisable to obtain an opinion from an independent valuation expert to the effect that the transaction is fair with respect to such plans.

Counsel, both internal and external, will play an important role in assuring that the boards' careful consideration of all relevant factors, including the opinions of advisors discussed above, is well documented.