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Acquiring Ownership: Considerations in Acquiring a "Controlling" Interest in a US Insurance Company

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Investing in a US insurance company presents unique concerns to any investor. This is particularly the case if such an investment would result in the investor becoming a "control" person of an insurance company. Generally, if an investor acquires ten percent or more of the voting securities of an insurance company, either directly or through the acquisition of similar interests in one or more intermediate entities, it will be considered to be acquiring a "controlling" interest in the insurance company. That fact will have two important consequences: (a) the investor will first need to receive approval from the insurance regulatory authority of the state in which the insurance company is domiciled; and (b) following the receipt of such approval, the investor will be subject to that domiciliary state's laws governing insurance holding company systems, which include ongoing reporting and compliance requirements.

Accordingly, prior to taking steps toward an acquisition which would give it a "controlling" interest in an insurance company, a potential investor should determine whether being subject to a highly structured and time-consuming approval process is acceptable, and whether it is willing to be subject to the ongoing compliance requirements of the insurance holding company laws.

Definition of "Control"

In most states, the insurance holding company laws are based on a model "Insurance Holding Company System Regulatory Act" adopted by the National Association of Insurance Commissioners (NAIC). The definition of "control" in the NAIC model act includes a rebuttable presumption that "control" exists if a person owns, directly or indirectly, ten percent or more of an insurance company's voting securities.[1]

We quote the NAIC model act definition of "control" in full, before commenting on it below:

> "Control." The term "control" (including the terms "controlling", "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or nonmanagement services, or otherwise, unless the power is the result of an official position with or corporate office held by the person. Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing, ten percent (10%) or more of the voting securities of any other person. This presumption may be rebutted by a showing made in the

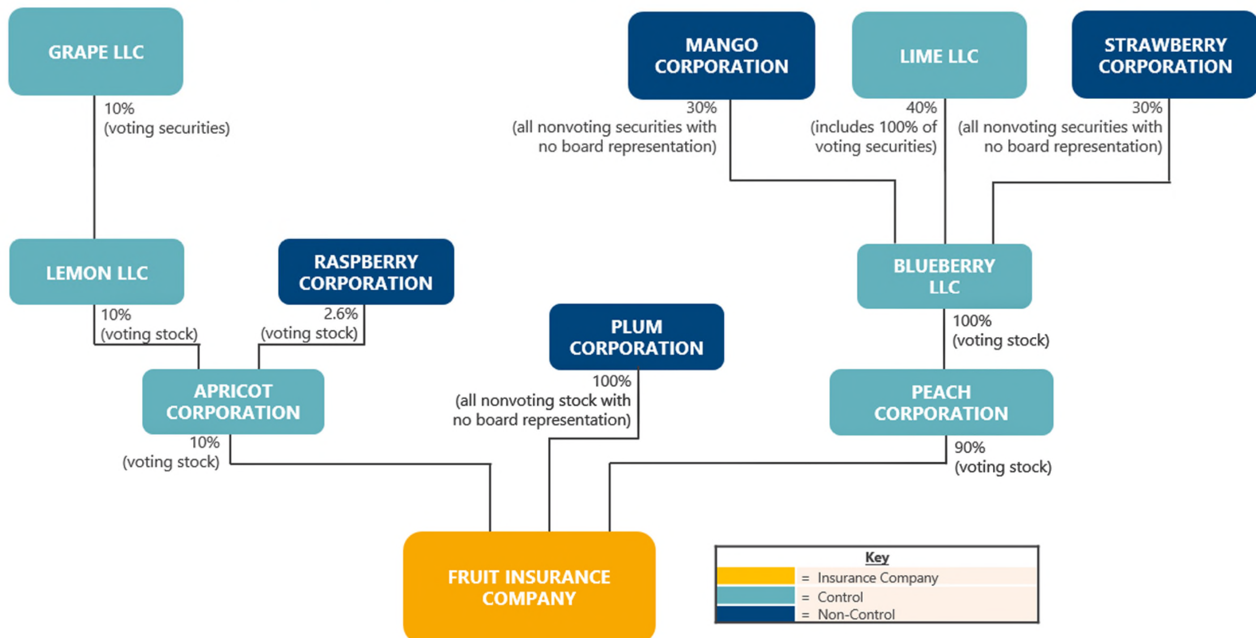
manner provided by Section 4K [*i.e.,* the disclaimer procedure discussed below] that control does not exist in fact. The commissioner may determine, after furnishing all persons in interest notice and opportunity to be heard and making specific findings of fact to support the determination, that control exists in fact, notwithstanding the absence of a presumption to that effect.

First, the focus of the concept of "control" is on an insurance company's voting securities. Accordingly, the direct or indirect ownership of ten percent or more of an insurance company's nonvoting securities is not sufficient to make the owner a "control" person. In the illustrative diagram below, Plum Corporation, which owns 100 percent of Fruit Insurance Company's nonvoting stock, is not considered to be a control person of Fruit Insurance Company, even though Apricot Corporation, which owns ten percent of Fruit Insurance Company's voting stock, is considered to be a "control" person of the insurance company.

Second, directly or indirectly holding ten percent or more of the voting securities of an insurance company triggers a rebuttable presumption of "control." Accordingly, if an investor were to acquire an ownership interest of ten percent or more of the voting stock of an entity which is itself considered a "control" person of an insurance company, then the investor would also be considered a "control" person of the insurance company through the intermediate entity. In the illustrative diagram below, Lemon LLC, which owns ten percent of the voting stock of Apricot Corporation, which in turn owns ten percent of the voting stock of Fruit Insurance Company, is considered to be a "control" person of Fruit just as Apricot is considered to be a "control" person of Fruit.

Third, if an investor acquires a controlling interest in an intermediate controlling entity of an insurance company, then it would be considered a "control" person of the insurance company through the entities in the preexisting chain of ownership, and furthermore the investor would be considered an ultimate "control" person of the insurance company if the investor was not itself controlled by any other person. In the illustrative diagram below, Grape LLC holds ten percent of the voting securities of Lemon LLC. Grape LLC has an ownership structure in which no single securityholder holds ten percent

Controlling Interests in Insurance Companies



or more of the voting securities (and each securityholder is independent of the other securityholders). Grape LLC is considered to be an ultimate "control" person of Fruit Insurance Company.

A crucial point to note is that "control" does not get diluted as one goes up a corporate organizational structure; the existence of "control" is tested at each level in a chain of ownership. So, in our example, Lemon LLC is not treated as a one percent indirect owner of Fruit Insurance Company based on the fact that it is a ten percent owner of a ten percent owner. Rather, it is treated as the "control" person of Apricot Corporation, and therefore as the indirect "control" person of Fruit Insurance Company.

Additionally, when determining if "control" is actually present, insurance regulatory authorities also tend to examine whether other indicators of "control," in addition to ownership of voting securities, may be present. Such indicators can include any factors that would allow a person to "direct or manage" the affairs of an insurance company. One example would be the right to designate one or more members of the board of directors of the insurance company or its parent. Another would be a management contract, by which the management of the insurance company is, in effect, turned over to another entity. Though unusual, in some cases, an insurance regulatory authority could find "control" to be present even where a potential investor does not hold ten percent of an insurance company's voting securities if there are other indicators of control in addition to a significant ownership interest.

Finally, while "control" may be presumed to exist if an investor holds ten percent or more of the voting securities of an insurance company, a person who technically meets this definition but is truly a passive investor can seek to rebut this presumption by making what is commonly termed as a "disclaimer of control" filing with the insurance regulatory authority in the state where the insurance company is domiciled. We will discuss this process next.

Disclaimers of Control

What insurance regulatory authorities focus on is whether a potential investor will be able to utilize its ownership of voting securities to direct the management or affairs of an insurance company. Ownership of ten percent or more of the voting securities of an insurance company creates a presumption of control, but potential investors have the option of attempting to rebut such a presumption by submitting what is called a "disclaimer of control" filing.

Potential investors who are purely passive economic investors in insurance companies are generally able to submit disclaimer of control filings to avoid being treated as "control" persons of those companies. The disclaimer of control filing sets out the facts that demonstrate the passive nature of the proposed investment. Upon the filing and approval of such a filing, a potential investor is usually allowed by a state insurance regulatory authority to hold ten percent or more of the voting securities of an insurance company, particularly where such an ownership interest does not carry any board membership rights.

In other instances, a potential investor could acquire voting securities amounting to ten percent or more of the outstanding voting securities, but would commit in its disclaimer filing to exercise its discretionary voting power over only 9.9 percent of the outstanding voting securities, and to vote the remainder of its voting securities in such a manner as to mirror the way all other votes are cast. In this circumstance, insurance regulatory authorities will often allow an investor to hold up to 19.9 percent of an insurance company's voting securities, on the basis that the additional voting securities

above the 9.9 percent voting threshold will effectively be a passive economic investment. However, insurance regulatory authorities will generally decline to allow an investor to hold in excess of 19.9 percent of an insurance company's voting securities without the filing of a Form A application (discussed below), regardless of whether the potential investor has committed to a 9.9 percent voting limitation.

Form A Applications

If an investor determines that it is comfortable with being treated as a "control" person of an insurance company, it will need to file an application for approval of an acquisition of control with the insurance regulatory authority in the insurance company's state of domicile.[2] This application is commonly called a "**Form A**" based on the terminology used in the NAIC "Insurance Holding Company System Model Regulation."[3] Most states utilize the Form A template provided in the NAIC model regulation, although some states have modified that template to a greater or lesser degree.

A Form A application is a substantial filing, which state insurance regulatory authorities generally take several months to evaluate. The Form A application must include, among other elements, a detailed description of the terms under which ten percent or more of the voting securities of an insurance company are going to be acquired by the potential investor, a description of the history and business operations of the investor, an examination of the future plans which the investor may have with respect to the insurance company and a background screening process for the investor's directors and executive officers to ensure that such individuals are fit and proper persons to exercise management authority over an insurance company.

While some states only require the person who is actually acquiring the ownership in the target insurance company (or in the target insurance company's ultimate controlling person) to be listed as the applicant on a Form A application, the overwhelming majority of US jurisdictions require all controlling persons of such an acquiring party to also be included as Form A applicants.

In addition to the Form A application itself, approximately 26 states require the holding of a public hearing as part of their evaluation of a Form A application,[4] at which members of the public can present testimony in support of or against the proposed acquisition. In most cases, the public hearing is a pro forma affair, with only representatives of the acquirer, the target insurance company and the regulatory authorities present, there is always the potential for other persons with an interest in the transaction to be present, and in any case the time required for scheduling and holding the public hearing needs to be taken into account.

Form E Notifications

The Form A application process is focused on the state or states where the target insurance company is domiciled (or deemed commercially domiciled). But the NAIC model act and regulation also include a process (which has been adopted in apprxomiately 39 states) for a proposed acquisition of a "controlling" interest in an insurance company to be reviewed by the insurance regulatory authority in any state where the insurance company is licesned to do business – in order to evaluate whether such an acquisition will have an anticompetitive impact on their local insurance marketplace.

Referred to as "**Form E notifications**" based on the template provided in the NAIC model regulation, these filings are essentially antitrust examinations at the state level, which examine the combined market share of the insurance company and the potential acquiring parties in each "line of business"[5]

written by the insurance company in that state following a potential acquisition. Generally, statutes that govern Form E notifications do not require filings where:

- the combined market share of the involved insurance companies would not exceed five percent of the total market in a given line of business;
- the acquisition in question would not result in any increase in any market share for any line of business; or
- the combined market share of the involved insurance companies would not exceed 12 percent of the total market for a given line of business, nor would the market share increase by more than two percent of the total market for such line of business.

However, even if a proposed acquisition would not qualify for any of the above exemptions, a potential investor can still establish the absence of an anticompetitive effect in a jurisdiction based on other substantial evidence. In order to establish that a proposed acquisition would not have an anticompetitive impact, a potential investor would need to discuss other mitigating factors, which could include, among others, (i) the market shares of other market participants, (ii) the volatility of ranking of market leaders, (iii) the number of other competitors in the market, (iv) how concentrated a line of business is, and (v) ease of entry and exit into the market.

Unlike a Form A application, which requires a formal approval from the insurance regulatory authority, the Form E notification obligation is fulfilled if the insurance regulatory authorities in a state do not disapprove the filing (or request additional information) within 30 days.

Ongoing Compliance and Notification Requirements

If a Form A applicant successfully receives approval of its application (and fulfills all applicable Form E notification requirements), then upon completion of the investment transaction it will become subject to ongoing compliance requirements in the state of domicile of the insurance company in which it has invested. For example, information about the ultimate controlling person and all of its subsidiaries is required to be included in the Form B Registration Statement that is filed annually by the insurance company. And, in many states, the ultimate controlling person of an insurance company is required to file a Form F Enterprise Risk Report that discusses the material risks within the ultimate controlling person's corporate structure that could pose enterprise risk to the insurance company. In addition, material transactions between an insurance company and any entity that controls it, or is under common control with it, are subject to a Form D Prior Notification filing before they can be entered into. It is also important to note that the ability of investors in an insurance company to extract dividends from the insurance company is regulated by statute and may require an advance notification filing with the domiciliary state regulatory authority. So clearly, not only is the acquisition of control of an insurance company a highly regulated undertaking, but the regulatory obligations and constraints that attach to such a control relationship once it has been established are also quite significant.[6]

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Endnotes

[1] NAIC INSURANCE HOLDING COMPANY SYSTEM REGULATORY ACT (MODEL 440), § 1C (available at https://www.naic.org/store/free/MDL-440.pdf). Alabama is an outlier in that its insurance holding company laws establish a presumption of control based on the ownership, direct or indirect, of *five* percent, as opposed to ten percent, of an insurance company's voting securities. ALA. CODE § 27-29-1(3).

[2] Some states (California, Florida, and Texas are notable examples) will deem an out-of-state insurance company to be "commercially domiciled" in the state if the company meets certain thresholds for business activity in the state (typically based on a percentage of business written in that state over the course of the most recent three years). If an insurance company is commercially domiciled in a state other than its state of legal domicile, then a Form A application may need to be filed in both the state of legal domicile and the state of commercial domicile.

[3] NAIC INSURANCE HOLDING COMPANY SYSTEM REGULATORY ACT (MODEL 450), Appendix A (available at https://www.naic.org/store/free/MDL-450.pdf).

[4] Generally, the holding of a public hearing is at the discretion of an insurance regulatory authority. While all US insurance regulatory authorities have the ability to hold a public hearing on a Form A application, only 26 routinely choose to do so. In addition, the NAIC model act requires a public hearing before an insurance regulatory authority can disapprove a Form A application.

[5] A "line of business" is a classification of a particular type of business written by insurance companies, such as fire insurance or ocean marine insurance.

[6] More details regarding these other types of holding company act filing requirements can be found in the NAIC model act and model regulation (see notes 1 and 3 for links to those documents).