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M&A ACADEMY

M&A Considerations in the Insurance Sector

Speakers:

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What is an Insurance M&A Transaction?

- Any M&A Transaction that reaches the insurance sector. Targets or acquirors can consist of:
 - Risk Bearing Entities
 - Stock Insurance Companies (controlled by equityholders)
 - Mutual Insurance Companies and Reciprocal (controlled by policyholders or attorney in fact)
 - Captives (wholly owned by insureds)
 - Non-Risk Bearing Entities (licensing is regulated but there are no financial tests)
 - Producers (Agents and Brokers)
 - Underwriters (Managing General Agents/Underwriters and Program Managers)
 - Insurtech
 - Begin with a focus on distribution and marketing and gradually move toward full-stack insurance



Regulatory Framework (General)

- There are several levels of regulation within the insurance industry:
 - State-Level Regulation
 - Focus on Solvency:
 - Guaranty Funds
 - Risk Based Capital and Reserves
 - Focus on Consumer Protection:
 - Rates and Forms
 - Market Conduct
 - Competition
 - Licensing (Lines of Business)
 - Individual transactions are reviewed and approved
 - National Association of Insurance Commissioners (U.S. standard-setting and regulatory support organization). Led by the commissioners of the 50 states and develops model rules and regulations.

Insurance Companies – Regulatory Due Diligence

- Due to regulatory requirements, there can be a wealth of publicly available information (state insurance department websites) with which to begin diligence:
 - Form A (filed each time there is a change of control of a domestic insurer)
 - Form B (annual registration statement filing – describes material transactions and litigation)
 - Form D (filed in connection with material intercompany transactions)
 - Triennial Examination Reports
 - Market Conduct Reports
 - Regulatory Investigations/Inquiries
 - Rate/Form Filings
 - Risk Based Capital Levels
 - Guaranty Fund Assessments

Insurance Companies – Regulatory Due Diligence (Cont'd)

- Other important regulatory focused due diligence includes:
 - Licenses and Certificates of Authority
 - It is important to understand (a) what jurisdictions is the target authorized in, (b) what lines of business is the target authorized for and (c) whether there any restrictions on the target's licenses.
 - Cybersecurity Compliance
 - Heightened regulatory sensitivity (NY DFS recently brought an enforcement action under cybersecurity rules). Other states have specific cybersecurity regulations.
 - Social Issues
 - There is increasing regulatory and investor scrutiny on environmental, social and corporate governance. Diligence should include questions about a target's initiatives.

Insurance Companies – Financial Due Diligence

- When conducting financial diligence, there are several important insurance-specific considerations to keep in mind:
 - Accounting standards are different - Statutory Accounting (GAAP v. SAP) and Related Quarterly Filings
 - GAAP assumes target will stay in business as a going concern.
 - SAP assumes target is in liquidation. The goal of SAP is to ensure solvency for the protection of policyholders. SAP financials are filed quarterly.
 - Insurance Companies are required to carry reserves. Reserve diligence is usually conducted in-house or by an independent actuary. There should be a focus on sufficiency and trends with respect to reserving.
 - It is important to understand the capital structure. In addition to understanding equity ownership, diligence should focus
 - Surplus Notes – Debt instrument but treated like equity with regulatory approval required for repayment.
 - Reinsurance – Risk ceded to free up capital for writing additional business.
 - Insurers are permitted to make investments but investments are regulated. In addition to understanding historical investments and the general investment portfolio, diligence should focus on permitted and non-permitted investments. Non-permitted investments reduce available capital.
 - A request should be made for all rating agency filings to understand the rating agency's view on the insurer.

Insurance Companies – Operational Due Diligence

- Each of the following should be addressed in operational due diligence:
 - Determine what intercompany and affiliate arrangements are in place.
 - Inquire whether there are shared services, how investments are managed across the broader organization and whether there are any tax sharing arrangements in place.
 - Keep in mind that the separation of shared arrangements and services could have regulatory implications.
 - Inquire as to how claims are handled and whether there is a history of extra-contractual liabilities (fraud and bad faith).
 - Diligence the systems and technology used to determine whether all systems will easily transfer and whether they are segregated systems. These systems could relate to sales, underwriting and claims handling.
 - Ask about reinsurance programs and the risks that are both ceded and retained by the target. Reinsurance will affect the financial statements, and diligence should focus on the extent to which reinsurance affects such statements.
 - Determine how the target distributes its insurance policies. It could use a mix of direct/independent agents and MGAs and MGUs
 - Confirm whether there are any fronting arrangements
 - Fronting is the use of a licensed, admitted insurer to issue an insurance policy without the intent to transfer any risk.
 - As previously noted, confirm the target's privacy requirements and compliance. For example, consider what state data privacy laws are applicable, whether HIPAA is applicable and/or whether the GDPR applies.

Producer and Underwriter Due Diligence

- Producer and underwriter diligence has its own focus on (a) licensing, (b) asset ownership and (c) restrictive covenants.
 - Licenses for producers and underwriters are held at several different levels.
 - Entity and Individual
 - Individual
 - Designated Responsible Licensed Person – responsible for compliance with insurance laws. Important to ensure that a DRLP holds all lines for which the business is also authorized.
 - Principal assets consist of policy information (expirations, renewals, policyholder name and contact information).
 - Request carrier contracts to determine who owns policy information.
 - Request MGA/MGU Agreement to confirm underwriting authority, exclusivity and capacity
 - Review commission structures. If commissions arrangements are not a flat percentage of premium, they are required to be disclosed.
- Ask for and review customer complaint logs.

Transaction Structures and Considerations

- There are several possible transaction structures in insurance transactions:
 - Stock deals are traditional and common in the industry for standalone targets.
 - Asset sales are uncommon because policies cannot be novated without policyholder consent. However, the policyholder information and right to renew can be sold. In a renewal rights transaction, the in-force book is typically reinsured.
 - Fronting arrangements continue operations on the seller's paper but are reinsured by a buyer. A fronting fee is paid to the seller.
- Mutual company have many unique considerations and are not the subject of this presentation. However, three different transaction structures are:
 - Sponsored Demutualizations (converted to a stock company prior to sale)
 - Mutual/Mutual Mergers
 - Mutual Affiliations (buyer takes control of the target board and the target joins the buyer's reinsurance pool).

Material Deal Terms

- There are several material deal terms that are unique to insurance transaction.
- Purchase price calculations normally include payment on a dollar for dollar basis of a target's capital and surplus amounts because (a) capital is required on day one and (b) regulatory approvals are required to take an extraordinary dividend. Amounts paid in excess of capital and surplus reflect the value of the Target.
- Earn-Outs are more common with producer transactions. They are typically tied to earnings or revenue (net commissions and fees). Insurance company earn-outs may be tied to retention/renewal and/or reserves but are less common.
- Conditions to close may include the following:
 - Regulatory approval (risk-bearing entities)
 - Policyholder approval (mutual companies)
 - Maintenance of certain financial metrics (RBC levels, ratings, etc.). These are less common conditions and typically seen in distressed situations.

Material Deal Terms – Insurance Specific Representations & Warranties

- Certain representations are specific to insurance transactions.
 - Financial Statements. As discussed, financial accounting standards can consist of GAAP and SAP. It is not uncommon to have representations covering both standards.
 - Reserves. Reserve representations almost never guarantee the sufficiency of reserves. Instead, they focus on consistency of recording and a lack of intentional misstatements.
 - Litigation and Contracts. Because insurance targets are involved in litigation in the ordinary course of business (claims), litigation representations should include appropriate carve outs. Similarly, as insurance policies are contracts, consider how they fit within material contract representations.
 - Compliance with Insurance Laws and Regulations. Specific representations regarding compliance with license, market conduct, regulatory investigations, dividend limits and a lack of guaranty fund assessments are commonly included.
 - Reinsurance. Representations regarding the financial strength of reinsurers, the availability of credit for in-place reinsurance arrangements and the strength of collateral may be included.
 - Rating Agencies. It is common to include a representation that there are no conditional ratings or potential downgrades pending.
 - Privacy/Data Security. As previously noted, regulators may be focused on privacy and data security compliance and strong representations should be considered on the buy-side.
 - Affiliate Transactions.

Regulatory Approval Process

- As noted, in connection with a change of control (10% with rebuttable presumption) of a domestic insurer, a Form A Application must be filed. The application contains:
 - Description of Transaction
 - Control person credentials and financials
 - Business plan and projections
 - Biographical affidavits, background checks and fingerprints (each control person)
- A public hearing may be required.
- Regulators can condition approval on certain actions by the buyer (e.g. jobs, presence in state, etc.). A “Burdensome Condition” “out” is often negotiated in the transaction documents.
- Form D Filings are required for new intercompany arrangements.
- Form E Filings (state antitrust filings) are based on the line of business conducted by the target and the buyer.
- Buyer regulatory notice
- It is important to consider providing an “outside date” that provides sufficient time to complete the regulatory approval process. The Form A process can take six months.
- In producer transactions, regulatory interactions are mostly post-closing.

Key Takeaways From This Session

- Transaction Structure
 - Business and structure of target are key to determining appropriate deal structure
- Insurance Companies
 - Significant diligence is available via research of public filings for regulated entities
 - Regulatory relationships are important, both in diligence and throughout the transaction
 - Regulatory approval process should be considered through all stages of negotiation and documentation
- Producers
 - When assets are people, controlling the process is key
 - Value is driven by licenses, customer and carrier relationships and underwriting results
- Market Trends
 - Influx of private equity and increased regulatory scrutiny
 - Regulatory focus on AI and Big Data

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QUESTIONS?

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With experience structuring, negotiating, and closing complex acquisitions and divestitures of regulated insurance companies, brokerages, and in-force and run-off blocks of business, Jeff regularly handles major and middle-market insurance company and insurance brokerage transactions and financings and mutual company affiliations, both domestically and in cross-border transactions. In addition to the insurance industry, Jeff also represents clients across the financial services and technology sectors.

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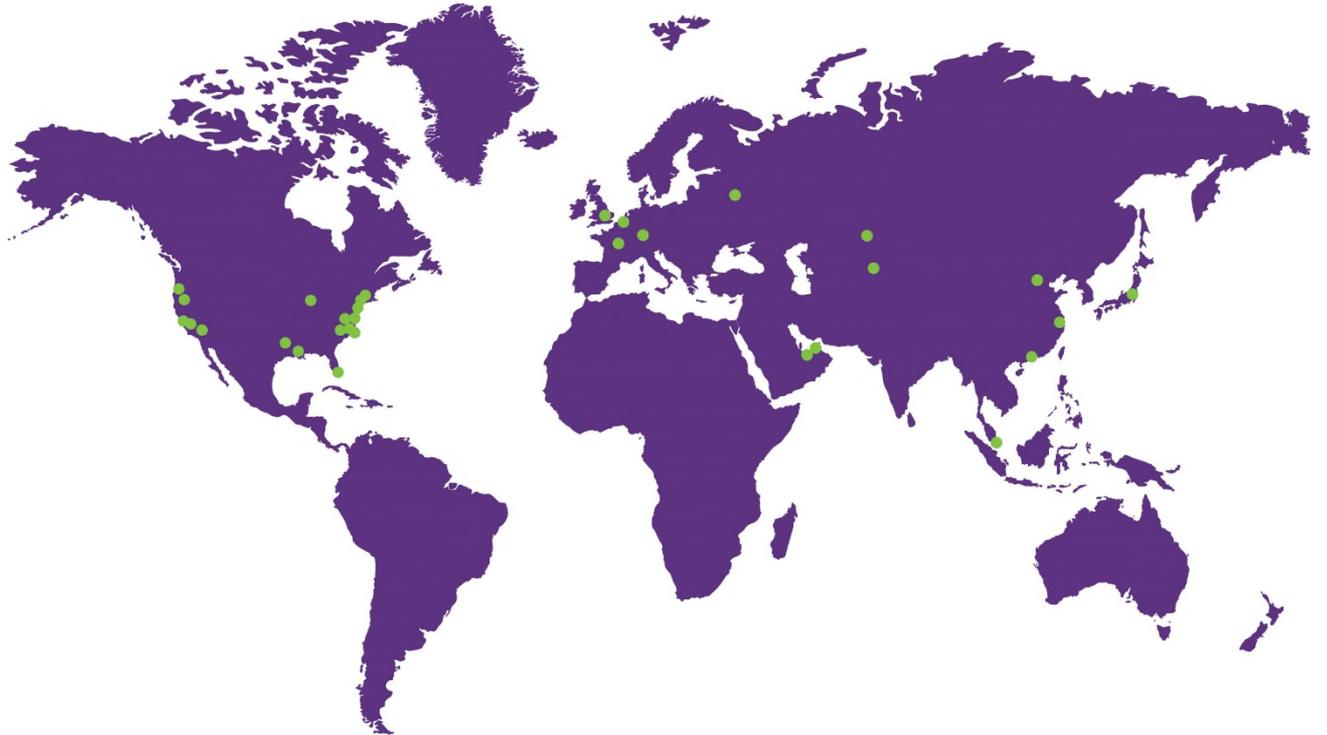
Spencer A.G. Curtis focuses his practice on mergers and acquisitions (M&A), investments, divestitures, private equity and debt financings, and general corporate and governance matters. Spencer has experience in cross-border and domestic public and private transactions across a broad range of often highly regulated industries. In particular, Spencer frequently guides clients in complex insurance and financial services industry transactions, including fintech and insurtech transactions, where he structures and negotiates strategic acquisitions and divestitures, joint ventures, equity investments, and recapitalizations, and manages the formation, financing, and licensing of new market entrants.

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