SULLIVAN & CROMWELL LLP

S&C memo

April 25, 2022

New York Department of Financial Services Issues Circular Letter Regarding Insurance Acquisitions and Disclaimers of Control

NYDFS Circular Letter Provides Guidance on Potential Control Issues in Transactions With New York Domiciled Insurers

SUMMARY

On April 19, 2022, the New York State Department of Financial Services (DFS) issued Insurance Circular Letter No. 5 (2022) (Circular Letter) to all New York domiciled insurers and "other interested parties."[1] The Circular Letter provides a summary of existing New York Insurance Law (NYIL) requirements governing determinations of "control." Under NYIL, similar to the insurance laws of other states, no person may directly or indirectly acquire "control" of a domestic insurer unless the Superintendent of the DFS provides its prior approval. While the Circular Letter does not change any existing laws or regulations, it provides guidance on how the DFS could broadly interpret existing laws and regulations governing control determinations, and sets forth the DFS' expectations in regard to transactions that raise potential control issues.

Examples of potential control issues addressed in the Circular Letter include transactions involving: the direct or indirect acquisition of an insurer's voting securities—even where the voting securities acquired represent less than 10% of the total voting securities (*i.e.*, are less than the 10% rebuttable presumption of control set forth under New York's and almost every other state's insurance laws); rights to appoint board members; new contractual arrangements with a transaction counterparty; or a combination of such factors. The DFS "urges parties contemplating a transaction that raises potential control issues . . . to engage with

the [DFS] as early in the transaction structuring process as practicable . . ." Parties contemplating investments in New York domiciled insurers, including institutional investors, even those intending to remain passive, should take into account the interpretations and expectations set forth in the Circular Letter, which may impact the structuring of the transaction and/or the timing of outreach and submissions to the DFS where potential control issues could be present.

CIRCULAR LETTER

The Circular Letter begins by noting that the DFS has "become aware that several potential investors in New York domestic insurers have structured their investments as an acquisition of less than 10% of the insurers' voting securities, at least in part, based on the expectation that an investment below that level would avoid filing and approval requirements." The DFS then further notes that some transactions have also been structured to limit an investor's board representation to a single board seat given that such level of board representation, "by itself, does not create a presumption of control." According to the DFS, an acquiror of less than 10% of an insurer's voting securities, or with a right to appoint a single board member, may still be deemed to control an insurer based on the facts and circumstances of the proposed transaction. Given what it refers to as the "apparent misconception in the marketplace" (*i.e.*, that acquisitions below 10% of voting securities or with only a single board seat right would effectively benefit from a safe harbor from filing and approval requirements) and "the recent increase in insurance company transactions," the DFS "wishes to remind industry participants" of the requirements of the NYIL and the DFS's expectations.

The key statutory provisions involved in determining control under the NYIL are:

Control definition. "Control" is defined under NYIL § 1501(a)(2) to mean "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 (except a commercial contract for goods or non-management services) or otherwise; but no person shall be deemed to control another person solely by reason of his being an officer or director of such other person."

Rebuttable presumption. NYIL § 1501(a)(2) further provides that "control shall be presumed to exist if any person directly or indirectly owns, controls or holds with the power to vote ten percent or more of the voting securities of any other person."[2]

Disclaimer of control. This rebuttable presumption is, however, subject to NYIL § 1501(c), which provides that the Superintendent "may determine upon application that any person does not or will not upon the taking of some proposed action control another person." Accordingly, the Superintendent may make a determination of non-control (typically called a "disclaimer of control") even where a person acquires, directly or indirectly, in excess of 10% of the voting securities of an insurer. Under NYIL § 1501(c), the Superintendent may "prospectively revoke or modify" a disclaimer of control determination, after notice and opportunity to be heard, "whenever in his judgment revocation or modification is consistent" with NYIL requirements.

Controlling influence. NYIL § 1501(b) makes clear that, notwithstanding the definition of "control" and the rebuttable presumption, the Superintendent "may determine, after notice and opportunity to be heard, that a person exercises directly or indirectly either alone or pursuant to an agreement with one or more other persons such a controlling influence over the management or policies of an authorized insurer as to make it necessary or appropriate in the public interest or for the protection of the insurer's policyholders or shareholders that the person be deemed to control the insurer."[3] Thus, even where an investor (or group of investors) is acquiring less than 10% of an insurer's voting securities (or the voting securities of the ultimate control person of the insurer or any person within the ownership chain above the insurer), the Superintendent may determine control nonetheless exists on account of other *indicia* of control, such as board representation, governance rights, investment or other contractual arrangements, or a combination thereof.

The Circular Letter summarizes these statutory provisions, and provides additional color on how the DFS interprets them. The Circular Letter emphasizes that a determination of control "depends on all the facts and circumstances." Of the rebuttable presumption, the Circular Letter notes that "this presumption does not create a safe harbor for acquisitions below the 10% threshold, which may still result in a control determination." In addition, the Circular Letter states that while NYIL § 1501(a)(2) provides that "no person shall be deemed to control another person solely by reason of his being an officer or director of such other person," facts such as being a director or having the right to appoint a director "may, in combination with other factors, lead to a control determination." Finally, the DFS asserts that the NYIL "makes clear that a control relationship can arise from a contract or other factors, in the absence of ***any*** ownership of voting securities of an insurer" (emphasis in original). While the statutory definition of control does, in fact, include

"the power to direct or cause the direction of the management and policies of a person . . . by contract (except a commercial contract for goods or non-management services)," the Circular Letter does not provide any guidance as to what kinds of contractual relationships may, in the DFS's view, indicate a controlling influence, whether in conjunction with or in the absence of any ownership rights. Ongoing work at the National Association of Insurance Commissioners (NAIC) in respect of private equity and other investments in insurers (discussed below) has singled out investment management arrangements as a key regulatory consideration, but the Circular Letter does not address the extent to which investment management or other types of contractual arrangements (*e.g.*, administrative servicing or reinsurance) could raise potential control issues.

The DFS "urges parties contemplating a transaction that raises potential control issues (including, but not limited to, transactions involving the acquisition of an insurer's voting securities by, the grant of a board seat to, or a new contractual relationship with, a transaction counterparty, or any combination of these factors) to engage with the [DFS] as early in the transaction structuring process as practicable, even if the parties believe that such transaction will not give rise to a control relationship, to give the [DFS] a reasonable opportunity to review the transaction and the parties' position." The DFS "encourages this informal engagement" to avoid delay and other adverse consequences, including penalties under NYIL § 1510(a),[4] in the event the Superintendent reaches a different conclusion. The DFS concludes by noting that if, notwithstanding the parties' position, the Superintendent determines that the transaction would result in a change of control, the parties must either submit an application under NYIL § 1506 (*i.e.*, a so-called "Form A" application seeking prior approval of the change of control from the Superintendent) or request a disclaimer of control under NYIL § 1501(c).

Although the Circular Letter encourages persons contemplating a very wide variety of transactions and arrangements involving a New York domiciled insurer to consult with the DFS on the control issue, certainly not every investment in or contract with an insurer "raises potential control issues." It remains to be seen whether the DFS intends to expand the concept of control well beyond precedential determinations and prior policy.

RELATED DEVELOPMENTS

The Circular Letter comes during a time of increased attention by state and federal policymakers to acquisitions of control or other investments in insurers, including a renewed interest in private equity

investments in insurers, which have seen a substantial increase over the past few years.[5] In particular, the NAIC has shown renewed interest on this topic and continues to review and revise its "Regulatory Considerations Applicable (But Not Exclusive) to Private Equity (PE) Owned Insurers" (NAIC List).[6]

NAIC PE Considerations List

The NAIC List identifies 13 considerations related to private equity or other investments in, and control of, insurers.[7] The NAIC List remains under review and is expected to be revised further, and it is unclear what action items may result from the final list (*e.g.*, revisions to NAIC model laws or handbooks), which would, if recommended, require additional review and adoption procedures. Nonetheless, the content of the NAIC List and the interest shown by NAIC members indicates a renewed concern regarding private equity and other complex investments in insurers, and could have a significant impact on how state insurance regulators will review pending or future change-of-control transactions and disclaimer of control filings involving any such parties.

The 13 considerations are:

(i) Regulators may not be obtaining clear pictures of risk due to holding companies structuring contractual agreements in a manner to avoid regulatory disclosures and requirements. Additionally, affiliated/related-party agreements impacting the insurer's risks may be structured to avoid disclosure (for example, by not including the insurer as a party to the agreement).

(ii) Control is presumed to exist where ownership is equal to or greater than 10%, but control and conflict of interest considerations may exist with less than 10% ownership.[8]

(iii) The material terms of any investment management agreement and whether they are arm's length or include conflicts of interest, including the amount and types of investment management fees, termination provisions, and degree of discretion or control of the investment manager over investment guidelines, allocation and decisions.

(iv) Owners of insurers, regardless of type and structure, may be focused on short-term results which may not be in alignment with the long-term nature of liabilities in life products.

(v) Operational, governance and market conduct practices being impacted by the different priorities and level of insurance experience possessed by entrants into the insurance market without prior insurance experience, including private equity owners; for example, a reliance on third-party administrators (TPAs) due to the acquiring firm's lack of expertise may not be sufficient to administer the business.

(vi) No uniform or widely accepted definition of private equity and challenges in maintaining a complete list of insurers' material relationships with private equity firms.

(vii) The lack of identification of related-party originated investments (including structured securities). This may create conflicts of interest and excessive and/or hidden fees in the portfolio structure.

(viii) Though annual statutory financial statements include affiliated investment disclosures, it is not easy to identify underlying affiliated investments and/or collateral within structured security investments, and transactions may be excluded from affiliated reporting due to nuanced technicalities; regulatory disclosures may be required to identify related-party investments and/or collateral within structured security investments.

(ix) Broader considerations exist around asset manager affiliates (not just private equity owners) and disclaimers of affiliation avoiding current affiliate investment disclosures.

(x) Material increases in privately structured securities (both by affiliated and nonaffiliated asset managers), which introduce other sources of risk or increase traditional credit risk, such as complexity risk and illiquidity risk, and involve a lack of transparency.

(xi) The level of reliance on rating agency ratings and their appropriateness for regulatory purposes (*e.g.*, accuracy, consistency, comparability, applicability, interchangeability and transparency).

(xii) The trend of life insurers engaging in pension risk transfer business and supporting such business with the more complex investments outlined above.

(xiii) Insurers' use of offshore reinsurers (including captives) and complex affiliated sidecar vehicles to maximize capital efficiency, reduce reserves, increase investment risk and introduce complexities into the group structure.

Senator Brown Letter to FIO and NAIC

As a further related development, on March 16, 2022, Senator Sherrod Brown (D-OH, Chair of the Senate Banking, Housing and Urban Affairs Committee) sent a letter to the Federal Insurance Office (FIO) and the NAIC to express his "concern that insurance investment products workers depend on for their retirement are being transferred to these risky companies [referring to alternative asset managers like private equity firms] that have a track record of undermining pension and retirement programs."[9] Senator Brown requested that the FIO, in consultation with the NAIC, work to collect additional data from insurers and issue a report to Congress that evaluates certain broad concerns by May 31, 2022, including, among other things, with respect to investment strategies pursued by private equity-controlled insurers, impact to pension plan beneficiaries of pension risk transfer arrangements, and risks of transparency arising from transfer of insurance obligations to non-public private equity and asset management firms.

* * *

ENDNOTES

[1] NYDFS, Insurance Circular Letter No. 5 (2022): Acquisitions of Control and Disclaimers of Control (Apr. 19, 2022), *available at* https://www.dfs.ny.gov/industry_guidance/circular_letters/cl2022_05. New York domiciled insurers (also called "domestic insurers") include insurance companies incorporated in New York and insurers incorporated outside New York that are deemed to be "commercially domiciled" in New York pursuant to NYIL § 1501(d).

[2] "Voting securities" are defined under the NYIL to mean "securities of any class or any ownership interest having voting power for the election of directors, trustees or management of an institution, other than securities having such power only by reason of the happening of a contingency." NYIL § 107(a)(45).

[3] "Person" for purposes of NYIL Article 15 (*i.e.*, the holding company laws that govern acquisitions of control, affiliate transactions and holding company requirements) is defined as "an individual, partnership, firm, association, corporation, joint-stock company, trust, any similar entity or any combination of the foregoing acting in concert." NYIL § 1501(a)(1). Thus, ownership interests held by otherwise unaffiliated companies acting in concert via contractual or other arrangements may be aggregated for purposes of determining whether control exists.

[4] Penalties under NYIL § 1510 include liquidation or rehabilitation proceedings against the domestic insurer; revocation of licenses; civil actions brought against persons willfully violating the NYIL requirements; or specified monetary penalties.

[5] *See*, *e.g.*, Federal Insurance Office, Annual Report on the Insurance Industry 50 (Sept. 2021), Section II.B.4, *available at* https://home.treasury.gov/system/files/311/FIO-2021-Annual-Report-Insurance-Industry.pdf.

[6] The NAIC formed a Private Equity Issues Working Group in 2013 during an earlier period of regulatory concern regarding private equity investments in insurers, whose work culminated in 2015 with adoption of a section added to the NAIC's *Financial Analysis Handbook* regarding regulatory review of Form A change-of-control filings, which included a set of potential short-term stipulations and continuing or long-term stipulations that may be recommended in connection with potential risks involving acquisition of insurers by private equity or other investors. The most recent version of the NAIC List summarizes those stipulations, in addition to the other considerations under review.

[7] NAIC, Regulatory Considerations Application (But Not Exclusive) to Private Equity (PE) Owned Insurers (Apr. 5, 2022). An initial version of the NAIC List was exposed by the NAIC's Financial Stability (E) Task Force (FSTF) in December 2021. The list was adopted in February 2022 by the NAIC Macroprudential (E) Working Group (MWG) and the FSTF. On April 5, 2022, the FSTF and the MWG announced that the NAIC List had been updated after additional meetings with chairs of other NAIC committees. The updated version includes, among other additions, a plan as to how the NAIC intends to move forward on the first six of the 13 considerations. Another regulator-only session will be held to address the remaining seven considerations.

[8] In reference to this consideration, the NAIC List observes that a party may exercise a controlling influence over an insurer through board and management representation or contractual arrangements, including non-customary minority shareholder rights or covenants, investment management agreement provisions (*e.g.*, onerous or costly termination provisions), or excessive control or discretion given over investment strategy and implementation; asset management services may need to be distinguished from ownership when assessing and considering controls and conflicts.

[9] Sherrod Brown, Letter to the FIO and NAIC (Mar. 16, 2022), *available at* https://www.banking.senate.gov/imo/media/doc/brown_letter_on_insurance_031622.pdf.

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers or to any Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.