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Insurers in Crisis: Risks and Opportunities

by Wolcott B. Dunham, Steven Ostner, My Chi To and Alexander R. Cochran

The past few months have seen unprecedented events in our financial markets which have had wide ranging effects on financial institutions generally and insurance companies specifically. With these events has come a heightened focus on transactions with financially stressed companies, including insurance companies. This article discusses certain risks and opportunities presented by potential transactions with troubled insurers and some of the key legal considerations under U.S. law in such transactions. After a discussion of the U.S. legal framework governing transactions with troubled insurers generally, we turn to a high level overview of specific types of potential transactions with financially stressed insurers, including:

- bulk reinsurance acquisitions of a block of business;
- acquisitions of the equity of an insurer;
- investments in surplus notes issued by an insurer;
- investments in equity or debt issued by an insurance holding company; and
- acquisitions out of receivership.

Legal Background

There are important legal considerations that anyone structuring a transaction with a financially stressed insurance company should consider, including what would happen if the insurer entered receivership proceedings.

Receivership Proceedings

The insurance laws of an insurance company's domiciliary state govern insolvency proceedings involving the insurance company, referred to generally as "receivership proceedings". In most states, these domestic receivership proceedings take the form of either rehabilitation proceedings or liquidation proceedings. Rehabilitation proceedings are intended to preserve the financially stressed insurance company by removing the conditions that made the rehabilitation necessary and returning the insurer to business. In a rehabilitation proceeding, the receiver, or rehabilitator, can generally sue those believed to have caused the need for a rehabilitation and can dispute the validity of claims against the insurance company. A rehabilitation proceeding will end with either (i) the emergence of the insurer from rehabilitation as a result of its being returned to its shareholders or sold to an investor who infuses capital, or (ii) a conversion of the rehabilitation proceeding to a liquidation proceeding.

Liquidation proceedings are intended to terminate the insurance company's existence and provide for the winding up of its affairs. In a liquidation proceeding, the receiver, or liquidator, will sell assets and policyholders will submit claims prior to a specified bar date. To protect policyholders, the receiver or liquidator will often attempt to use the unearned premium reserve of the insurer to reinsure policies with a solvent reinsurer.

WHAT'S INSIDE

3 Allocation of Risk for Contingent Liabilities: What's Different About Insurance M&A?

7 Pending U.S. Federal Insurance Regulation Proposals Revisited

10 Open Market Debt Repurchases: Key Issues to Consider

General creditors of the insurer rank junior to policy claims in a liquidation proceeding. Receivership proceedings may generally be commenced upon any of several specified grounds under the law of the state of domicile of a financially stressed insurance company. Grounds for commencing receivership proceedings can include (i) the insurer is insolvent, (ii) the insurer is in such a condition that further transaction of its business will be hazardous to its policyholders, creditors or the public, (iii) the insurer has willfully violated state insurance law, or (iv) the insurer has voluntarily agreed to enter into receivership proceedings.

In the event that a receivership proceeding is commenced against an insurer, the state court overseeing the proceeding will generally appoint the state superintendent or commissioner of insurance as the receiver of the insurer. In a rehabilitation proceeding, the receiver will generally have the power to take actions necessary or appropriate to

Insurers in Crisis continues on page 11

Letter from the Editor

Over recent weeks and months we have seen unprecedented events unfold in the world financial markets. Volatility in global equity markets has increased to levels not seen in a generation. Global debt and equity indices have dropped precipitously and U.S. Treasury note yields have fallen to historic lows. In response, governments worldwide are implementing programs designed to shield financial and other companies from this market turmoil and reopen global credit markets.

In the United States, Congress passed the Emergency Economic Stabilization Act of 2008 ("EESA") on October 3, and the Act was signed into law the same day by President Bush. Under EESA, among other initiatives, the U.S. Department of the Treasury is implementing the Troubled Asset Relief Program Capital Purchase Program ("TARP CPP"). Certain financial institutions that are regulated as banks, savings and loan associations, bank holding companies or savings and loan holding companies, and that meet other criteria, are eligible to issue preferred shares and warrants to the Treasury under the TARP CPP. Many such institutions have already applied to participate, and been accepted, in the TARP CPP.

The final impact of recent events on the financial markets remains unclear, and will continue to evolve in 2009 and beyond. This issue of the Debevoise & Plimpton Financial Institutions Report includes articles that we hope you will find useful in the current market environment. Included in this issue are articles discussing risks and opportunities presented by potential transactions with troubled insurers, highlighting common post-closing risk allocation mechanisms in insurance M&A transactions and summarizing certain key considerations to keep in mind in connection with a debt repurchase program. Additionally, in light of the recent market turmoil, we review four proposals for U.S. federal insurance regulation introduced in the 110th Congress that may or may not influence future reform efforts.

As always, we will continue to monitor and report on these and other developments in the Debevoise & Plimpton Financial Institutions Report and in Client Updates.

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Editor-in-Chief

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Allocation of Risk for Contingent Liabilities: What's Different About Insurance M&A?

by Michael D. Devins and David Grosgold

The allocation of risk for post-closing contingent or unknown liabilities is one of the most heavily negotiated issues in many M&A transactions, regardless of industry. The framework for allocating risk between the buyer and the seller in a specific transaction will hinge on a number of factors, including the bargaining leverage of the parties and the specific risks likely to arise in a particular business. However, there are certain market practices, approaches and issues that are unique to the insurance industry. This article provides a general overview of some of the most common post-closing risk allocation mechanisms in insurance M&A.

Market Practice

Before beginning a detailed discussion of risk allocation in insurance M&A transactions, it is worth making a couple of preliminary observations. The past year has seen unprecedented developments in the world financial markets and current M&A market conditions are different from anything practitioners have seen in recent memory. As a result, at least some conventional wisdom about the "market" has quickly become obsolete and buyers and sellers, particularly with respect to distressed sellers and target companies, are now operating under a new and evolving paradigm where the allocation of risk of loss is a dynamic process that is changing and developing as market conditions evolve.

Nonetheless, we believe it is useful to examine recent trends and developments concerning risk allocation in insurance M&A transactions. In the last several years, a significant difference could be observed between the allocation of risk in insurance deals and deals in other industries. With the general M&A market fueled by "hot" auctions involving several private equity bidders, competing on contract terms as well as price, it was not unusual to see agreements with very seller-favorable risk allocation provisions such as representations and warranties that expire at closing or much lower indemnification caps than were common historically.

Absent specific contractual provisions to the contrary, the structure of a deal is the most basic risk allocation mechanism in M&A transactions.

The trend described above, while not completely absent in insurance transactions, did not develop to the same extent in the insurance industry. A number of factors may explain these differences. First, insurance company sales are less likely to draw significant private equity interest because the regulatory restrictions on leverage and dividend payments pose challenges to the traditional private equity business model and because private equity firms may be hesitant to submit the type of information required by insurance regulators in the deal approval process. This means that the dynamics of insurance company auctions may be less seller-favorable than the dynamics in other industries. Second, insurance sellers may be more sophisticated about risk since they are, after all, in the risk business, making them more receptive to the idea of retaining certain risks related to sold entities than sellers in other industries. Also, because insurance buyers and sellers are more conversant in concepts of risk, novel risk sharing approaches, such as those borrowed from reinsurance (e.g., indemnification by sellers of buyers for extra-contractual liabilities) have crept into insurance M&A agreements, and these concepts are often buyer-favorable.

Due Diligence

It is also worth saying a few words about the role of due diligence in an M&A transaction. While due diligence serves a valuable purpose in assisting a buyer in understanding and pricing the risks inherent in an acquired business, it is important to remember that due diligence does not in fact function as a risk allocation mechanism. Acquisition agreements often provide that the buyer has only relied on the representations and warranties found in the agreement and not on outside statements or implied representations. Therefore, absent fraud, a buyer cannot rely on materials provided during the due diligence process when seeking an indemnity or other claim against a seller. Even a fraud claim will likely be difficult to pursue. The elements of fraud require that the buyer must establish that the seller acted with a knowing intent to defraud and that the buyer relied on the information provided in due diligence. The fact that the acquisition agreement states that the buyer has in fact relied only on the representations and warranties found in the agreement may make it difficult for the buyer to argue that it relied on due diligence materials. Finally, the

Allocation of Risk continues on next page

Allocation of Risk for Contingent Liabilities

(continued from previous page)

acquisition agreement is likely to provide that absent fraud, the indemnities provided for in the agreement are the buyer's sole remedy with respect to the subject matter of the transaction, so any other legal claims will be difficult, if not impossible, to bring. Therefore, it is important that a buyer make sure that it receives adequate protections against contingent liabilities in the agreement itself.

The Structure of the Deal

Absent specific contractual provisions to the contrary, the structure of a deal is the most basic risk allocation mechanism in M&A transactions. The risk of loss for contingent and unknown liabilities is allocated differently by operation of law if the transaction is structured as a stock acquisition, a merger or a sale of assets of the target entity. In a stock sale or a merger, all contingent and unknown liabilities are transferred to the buyer. In a stock sale, contingent and unknown liabilities remain in most circumstances liabilities of the target company after the acquisition is completed and are therefore effectively transferred to the buyer as the new owner of the target company. In a merger, the surviving company is deemed to assume all of the liabilities of the constituent entities that were merged to form the surviving company. In contrast, in an asset sale, absent unusual circumstances, the buyer of assets acquires only those categories of assets specified in the acquisition agreement (although sometimes those categories are very broadly drafted to include all liabilities other than enumerated exceptions). In the insurance M&A context, asset sales typically take the form of a bulk reinsurance deal, where a buyer assumes only those assets required or beneficial in administering the acquired block of business. In this context, the buyer usually acquires only specified and known liabilities (e.g., obligations under the reinsured policies) and the agreement excludes other liabilities (e.g., extra-contractual liabilities).

Representations and warranties also have a risk allocation function, providing the buyer the right to be indemnified in the event the representations and warranties are not true or accurate as of specified times

As described in more detail below, contractual provisions may change the allocation of risk of loss for contingent and unknown liabilities irrespective of the structure. For example, the acquisition agreement will almost always contain representations and warranties made by the seller regarding the acquired business and (in a private M&A transaction) associated indemnities. The agreement may also provide for special standalone indemnities with respect to specific matters. In fact, as described above, buyers in insurance M&A transactions have tended to take a more conservative approach to risk allocation. It is not unusual to find indemnities in insurance M&A stock deals that, for example, carve out extra-contractual liabilities or even all contingent and unknown liabilities arising prior to the closing (sometimes known as "Our Watch/Your Watch" indemnities) notwithstanding that such indemnities are commonly found only in asset sales in the broader M&A market.

Representations and Warranties

Representations and warranties serve a number of functions in M&A transactions, including due diligence and disclosure as well as a closing condition allowing a buyer not to close the transaction if the acquired business materially deteriorates prior to the scheduled closing date. Coupled with the indemnity provisions in the acquisition agreement, representations and warranties also have a risk allocation function, providing the buyer the right to be indemnified in the event the representations and warranties are not true or accurate as of specified times (usually the date of the agreement and the date of the closing). Representations and warranties are often subject to scheduled exceptions and materiality and knowledge qualifiers, although materiality qualifiers in particular may be ignored for indemnification purposes. The seller's indemnity obligations are commonly limited by caps, deductibles and time limits for bringing a claim. The advantage of representations and warranties as a risk allocation mechanism is that representations and warranties allow the buyer to be informed of known risks that can be "priced into" the transaction while permitting the buyer to be protected against certain categories of unknown or difficult to quantify risks. One disadvantage of representations and warranties from the buyer's perspective, in addition to the fact that indemnities are subject to caps, deductibles and limited survivability, is that a degree of specificity is necessary with respect to the description of the risks for which protection is sought, so it is possible

Allocation of Risk continues on next page

Allocation of Risk for Contingent Liabilities

(continued from previous page)

for the representation and warranty package to be underinclusive. This is particularly true in the context of contingent and unknown liabilities that are difficult to predict or describe at the time the agreement is signed.

Insurance Specific Representations and Warranties

Because representations and warranties need to be specific to provide the buyer the protection it seeks, there are typically representations and warranties that are unique to insurance M&A deals, designed to cover risks that are specific to the insurance industry. It is common, for example, to find representations and warranties addressing the target's compliance with applicable insurance laws, the accuracy of its books and records, its licensing and filed reports, rates and forms, and its relationships with producers and reinsurers.

Perhaps one of the most heavily negotiated representations in insurance M&A is the representation dealing with the target's policy reserves. Although there is usually some form of reserve representation in most insurance M&A deals, absent unusual circumstances, a seller will resist making a representation as to the sufficiency or adequacy of the reserves, which effectively amounts to a guarantee of reserve development. The reserve representation therefore generally focuses on the process used to determine the reserves rather than the amount of reserves itself. For example, the seller may represent that the reserves were determined in accordance with specified actuarial standards or statutory accounting principles, are consistent with any relevant contract provisions or are in compliance with applicable laws. Similarly, sellers resist making representations and warranties with respect to the collectibility of reinsurance recoverables, which is also viewed as a guarantee of future performance. Sellers sometimes agree instead to represent that the target company is entitled under applicable law to take full credit in its statutory financial statements for all amounts recoverable by it under its reinsurance agreements.

So-called Our Watch/Your Watch indemnities provide a blanket protection to buyers with respect to liabilities arising from actions or events occurring prior to the closing date.

In light of the fact that representations and warranties require a certain degree of specificity to provide buyers the necessary protection they seek, buyers in insurance M&A transactions often request representations and warranties with respect to matters that have been the subject of industry wide investigations or litigation. For example, a buyer may want the seller to represent that the target is not a party to any finite reinsurance arrangements. Similarly, the representations and warranties may also cover the sale practices of the target's producers or whether the target has paid any contingent commissions. In this context, M&A lawyers outside the insurance industry may be surprised when the seller is asked to represent, for example, that the target has paid all policy claims as they came due or that the company's books and records contain no data inaccuracies, which may seem to involve a level of detail unusual for an M&A transaction. However, these detailed representations may be necessary in order to ensure that serious insurance-specific risks are appropriately addressed by the representation and warranty framework. For example, the purpose of the claims paying representation is to ensure that the target will not be the subject of a claim that it acted in bad faith in adjusting policy claims, which may result in tort like damages, which are very unusual in a contract claim outside of the insurance industry. The purpose of the data inaccuracy representation is to ensure that policy liabilities are properly recorded in the books and records of the company used in the buyer's valuation model.

Excluded Liabilities/Special Indemnities

As discussed above, in most circumstances, representations and warranties are meant to provide protection against unknown risks. Known liabilities are usually excluded from their coverage and accounted for in the purchase price. In some instances, buyers will seek protection for specific known matters or categories of liabilities that are difficult to quantify or where even a small deviation from expectations would be catastrophic. Usually this protection will take the form of liabilities specifically excluded from the transaction and indemnified against or special indemnities for losses that do not result from a breach of representation or warranty. It is not uncommon to find such protection with respect to liabilities related to taxes, employee benefits and specific litigations or regulatory investigations. In insurance M&A deals, excluded liabilities or special indemnities are sometimes given with respect to liabilities arising out of sales practices and, more generally, "extra contractual liabilities," a concept borrowed from reinsurance that may be applied very

Allocation of Risk continues on next page

Allocation of Risk for Contingent Liabilities

(continued from previous page)

broadly in the M&A context to cover not just payments to policyholders outside the four corners of insurance policies, but any liabilities of an acquired business other than policy liabilities. It has been increasingly common for sellers, even in stock deals, to retain extra contractual liabilities arising out of actions prior to the closing. The advantage to a buyer of excluded liabilities and special indemnities is that, unlike representations and warranties, excluded liabilities and special indemnities are usually not subject to caps, deductibles or limited survivability.

Our Watch/Your Watch Indemnities

So-called Our Watch/Your Watch indemnities provide a blanket protection to buyers with respect to liabilities arising from actions or events occurring prior to the closing date. This type of indemnification effectively allocates risk to the seller of all contingent or unknown liabilities attributable to events or circumstances that took place prior to the closing, and may be in the form of a stand-alone indemnity for all liability resulting from pre-closing actions, events or circumstances or may be in the form of an exceptionally broad representation and warranty as to undisclosed liabilities. As with excluded liabilities and special indemnities, Our Watch/Your Watch indemnities typically have not been subject to caps, deductibles or limited survivability. In addition, there is no need for specificity in the agreement as to the nature of the liabilities being indemnified under an Our Watch/Your Watch indemnity, nor is the breach of a representation or warranty or the trigger of another special indemnity a prerequisite to an Our Watch/Your Watch indemnity. This type of indemnification is therefore the most buyer-favorable of the protections discussed in this article. While this type of indemnity is not common in M&A transactions generally, particularly outside of asset acquisitions, it is more frequently found in insurance M&A deals than in other industries.

Conclusion

There are a number of mechanisms that are used in insurance M&A to allocate the risk between sellers and buyers for contingent and unknown liabilities. Often, a combination of these various mechanisms is used as the way to most effectively address the parties' respective concerns and risk tolerance levels. As we have increasingly seen in recent months, the allocation of risk of loss in M&A in general and financial services M&A in particular is a dynamic process that changes and develops as market conditions evolve. ■

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Pending U.S. Federal Insurance Regulation Proposals Revisited

by John Dembeck

With the advent of the global economic crisis, inquiries are already being made in the U.S. Congress as to why things went so wrong and what can be done to prevent this from ever happening again. While much of the initial attention has been placed on the buyers of sub-prime mortgages and mortgage-related securities and the participants in the credit derivatives market, it is likely that the regulation of the entire U.S. financial services industry will be examined, including the regulation of insurance, which is currently state-based. In light of that possibility, revisiting the pending proposals for federal insurance regulation seems appropriate. Each of the pending proposals for federal insurance regulation seeks to address, among other things, the lack of uniformity of the regulation of insurance by the 50 states. Whether or not any of these proposals will be considered as part of a comprehensive federal financial services regulatory reform effort remains to be determined. However, a reform effort might embody all or part of any of these pending proposals. In any event, since each of these pending proposals was introduced in the 110th Congress (2007-2008), consideration of any or all of these proposals in 2009 or afterward would require introduction of new bills in the 111th or subsequent Congress.

Optional Federal Charter

Pending Legislation; Status. S. 40, the National Insurance Act of 2007, was introduced on May 24, 2007 and was referred to the Senate Committee on Banking, Housing, and Urban Affairs. The Committee held a hearing on insurance regulatory reform on July 29, 2008. H.R. 3200, the National Insurance Act of 2007, was introduced on July 26, 2007 and was referred to both the House Committee on Financial Services and the House Committee on the Judiciary. The House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises held hearings on insurance regulatory reform on October 3 and 30, 2007 and April 16, 2008.

Main Purpose of the Legislation. These bills authorize the issuance of federal charters and licenses for carrying out the sale, solicitation, negotiation and underwriting of insurance and other insurance operations, provide a comprehensive system for the federal regulation and supervision of national insurers and national agencies and provide for policyholder protections in the event of insolvency or the impairment of a national insurer.

Problem Sought to be Addressed. The problem these bills seek to address is the lack of uniformity of state regulation of insurance, including insurer licensing requirements, insurance product regulation, insurance market conduct regulation, reinsurance credit regulation and producer licensing requirements.

Whether the Legislation Creates a New Federal Insurance Regulator. Yes, these bills would create a new federal regulatory office, the Office of National Insurers, in the U.S. Department of the Treasury (the "ONI"). The ONI would be headed by the Commissioner of National Insurance who would be appointed by the President, with the advice and consent of the U.S. Senate. The ONI would be funded by fees and assessments.

General Description of the Legislation. These bills include a comprehensive scheme for regulating national insurers, national agencies and federally licensed insurance producers. National insurers and national agencies would be subject to supervision and examination by the Commissioner and may be subject to other reporting requirements. National insurers, national agencies and federally licensed insurance producers would be subject to enforcement of the federal insurance laws by the Commissioner. Under the bills, national insurers and national agencies may be chartered and licensed or a state insurer or state agency may convert to a federal charter. National insurers would be subject to comprehensive financial, product and market conduct requirements. Special rules would apply to reinsurance, acquisition of control, conversions and the regulation of insurance holding companies. If a national insurer were to fail, it would be subject to a receivership proceeding in which the ONI would be the receiver. Under the bills, the backstop for failed national insurers would be the same as that for state chartered insurers – the state insurance guaranty fund system – so long as state insurance guaranty funds meet certain federal minimum standards, including coverage standards. If a state insurance guaranty fund fails to meet the federal minimum standards, then a National Insurance Guaranty Corporation would provide coverage in that state for all national insurers and state chartered insurers. Each backstop would be funded by assessments made on other licensed insurers, both national insurers and state chartered insurers.

Federal Preemption of State Law. These bills generally would preempt state law with respect to the licensing, examination, reporting, regulation or other supervision of national insurers, national agencies and federally licensed insurance producers with certain exceptions. Among the main exceptions are (i) state unclaimed property

Pending U.S. Federal Insurance Regulation Proposals continues on next page

laws, (ii) state tax laws (states tax insurers, usually through a tax on policy premiums), (iii) certain laws relating to residual markets for property/casualty insurers, and (iv) compulsory insurance laws (e.g., workers' compensation and motor vehicle).

Recent U.S. Federal Insurance Regulation Proposals

Optional Federal Charter

S. 40, National Insurance Act of 2007 (introduced May 24, 2007)

H.R. 3200, National Insurance Act of 2007 (introduced July 26, 2007)

Nonadmitted Insurance and Reinsurance

H.R. 1065, Nonadmitted and Reinsurance Reform Act of 2007 (introduced February 15, 2007)

National Association of Registered Agents and Brokers Reform Act (NARAB II)

H.R. 5611, National Association of Registered Agents and Brokers Reform Act of 2008 (introduced March 13, 2008)

Office of Insurance Information

H.R. 5840, Insurance Information Act of 2008 (introduced April 17, 2008)

Nonadmitted Insurance and Reinsurance

Pending Legislation; Status. H.R. 1065, the Nonadmitted and Reinsurance Reform Act of 2007, was introduced on February 15, 2007. It passed in the House of Representatives on June 25, 2007 and was referred to the Senate Committee on Banking, Housing and Urban Affairs on June 26, 2007.

Main Purpose of the Legislation. This bill seeks to "streamline" the regulation of surplus lines insurance and reinsurance by the states through the preemption of certain state laws.

Problem Sought to be Addressed. The problems this bill seeks to address are (i) multistate regulation of premium taxes on surplus lines insurance and surplus lines brokers, and (ii) extraterritorial regulation of reinsurance credit by non-domestic state insurance regulators.

Whether the Legislation Creates a New Federal Insurance Regulator. No, this bill would not create a new federal insurance regulator. It seeks to achieve its goal of "streamlining the regulation of surplus lines insurance and reinsurance" through the selective preemption of state law.

General Description of the Legislation.

Surplus Lines Insurance. With respect to surplus lines insurance (referred to in the bill as "nonadmitted insurance"), the key elements of the bill are the following: (i) provides that no state, other than a home state of an insured, may require any premium tax payment for surplus lines insurance but that states may agree, by compact or otherwise, on how to allocate premium taxes paid to the insured's home state, (ii) subjects placement of surplus lines insurance solely to the statutory and regulatory requirements of the insured's home state and provides that only an insured's home state may require a surplus lines broker to be licensed to conduct surplus lines insurance with respect to the insured, (iii) prohibits a state from (x) imposing eligibility criteria for surplus lines insurers domiciled in a U.S. jurisdiction except in conformance with certain provisions of the NAIC Non-Admitted Insurance Model Act, and (y) prohibits a surplus lines broker from placing surplus lines insurance with, or procuring surplus lines insurance from, a surplus lines insurer domiciled outside the U.S. and listed on the NAIC International Insurers Department Quarterly Listing of Alien Insurers, and (iv) provides that, subject to certain conditions, a surplus lines broker seeking to procure or place surplus lines insurance in a state for an "exempt commercial purchaser" (a sophisticated purchaser that meets certain criteria) is not required to satisfy any state requirement to make a due diligence search to determine whether the full amount or type of insurance sought can be obtained from admitted (licensed) insurers.

Reinsurance. With respect to reinsurance, the key elements of the bill are the following: (i) prohibits a state from denying credit for reinsurance if the state of domicile of the ceding insurer recognizes credit for reinsurance for the insurer's ceded risk, and is either an NAIC-accredited state or has financial solvency requirements substantially similar to NAIC accreditation requirements, (ii) preempts extraterritorial application to a ceding insurer of additional specified kinds of non-domiciliary state law, except those with respect to taxes or assessments on insurers or insurance income, and (iii) provides that the state of domicile of a reinsurer will have sole responsibility for regulating the reinsurer's financial solvency, if the state is NAIC-accredited or has financial solvency requirements substantially similar to NAIC accreditation requirements.

Federal Preemption of State Law. This bill uses preemption of state law to achieve its goal of deference to the insured's home state in the case of certain matters relating to surplus lines insurance, deference to a ceding insurer's home state in the case of regulation of credit for reinsurance and deference to the reinsurer's domestic state in the case of the regulation of the financial solvency of the reinsurer.

PENDING U.S. FEDERAL INSURANCE REGULATION PROPOSALS CONTINUES ON NEXT PAGE

National Association of Registered Agents and Brokers Reform Act (NARAB II)

Pending Legislation; Status. H.R. 5611, the National Association of Registered Agents and Brokers Reform Act of 2008, was introduced on March 13, 2008. It passed the House of Representatives on September 17, 2008 and was referred to the Senate Committee on Banking, Housing, and Urban Affairs on October 2, 2008.

Main Purpose of the Legislation. This bill amends the Gramm-Leach-Bliley Act to reestablish the National Association of Registered Agents and Brokers (the "Association") as a nonprofit corporation whose purpose is to provide a mechanism through which licensing, continuing education and other insurance producer qualification requirements and conditions can be adopted and applied on a multi-state basis, while preserving the right of states to (i) license, supervise, discipline and establish licensing fees for insurance producers, and (ii) prescribe and enforce laws and regulations regarding insurance-related consumer protection and unfair trade practices.

Problem Sought to be Addressed. The problem this bill seeks to address is state barriers to non-resident licensing by state insurance producers.

Whether the Legislation Creates a New Federal Insurance Regulator. No, this bill would not create a new federal insurance regulator. It seeks to achieve its goal of ease of non-resident licensing of state insurance producers through selective preemption of state law.

General Description of the Legislation. The bill's key elements are as follows: (i) sets forth Association membership requirements, including a required criminal background check applicable to state-licensed insurance producers – a producer can become an Association member by being licensed in its home state, (ii) provides that Association membership authorizes an insurance producer to sell, solicit, negotiate, effect, procure, deliver, renew, continue or bind insurance in any state for which the member pays the licensing fee set by such state for any line or lines of insurance specified in such producer's home state license, and exercises all such incidental powers, including certain insurance-related activities, (iii) provides that Association membership is equivalent to a nonresident insurance producer license issued in any state where the member pays the licensing fee, (iv) preserves state consumer protection and market conduct regulation powers not inconsistent with the act, (v) authorizes the Association to place a member on probation or suspend or revoke the producer's membership, (vi) establishes a Board of Directors to govern and supervise the Association and its members – the Board would have 11 members consisting of 6 state insurance regulators and 5 insurance industry representatives, and (vii) preempts certain state laws (see below).

Federal Preemption of State Law. This bill uses preemption of state law to achieve its goal of simplified licensing of non-resident insurance producers. For example, state laws in all states would be preempted to the extent they impose any continuing education requirements on non-resident insurance producers. In addition, certain state laws in a state other than a member's home state would be preempted in order to facilitate ease of non-resident insurance producer licensing.

Office of Insurance Information

Pending Legislation; Status. H.R. 5840, the Insurance Information Act of 2008, was introduced on April 17, 2008. It was amended and reported out of the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises on July 9, 2008.

Main Purpose of the Legislation. This bill establishes an Office of Insurance Information (the "Office") in the Department of the Treasury that has certain powers (see below).

Problem Sought to be Addressed. The problems this bill seeks to address are (i) lack of information about the U.S. insurance industry being acquired and maintained by the U.S. government, and (ii) the inability of the federal government to negotiate trade agreements with foreign countries in the face of inconsistent state insurance laws.

Whether the Legislation Creates a New Federal Insurance Regulator. Generally speaking, the bill would not create a new federal insurance regulator. While the exercise of the authority of the Office may result in preemption of state insurance laws, the bill specifically provides that this authority is not to be construed to establish a general supervisory or regulatory authority of the Office or the Department of the Treasury over the business of insurance.

General Description of the Legislation. The bill's key elements are as follows: (i) directs the Secretary of the Treasury to serve as the principal advisor to the President and Congress on domestic and international policy issues regarding all lines of insurance except health insurance, (ii) establishes the Office, headed by a Director, within the Department of the Treasury, (iii) authorizes the Office to (x) receive and collect, and to analyze and disseminate, data and information, and issue reports regarding all lines of insurance, except health insurance, subject to certain exceptions, (y) coordinate federal efforts and establish federal policy on international insurance matters, and (z) determine whether state insurance measures

Pending U.S. Federal Insurance Regulation Proposals continues on next page

(CONTINUED FROM PREVIOUS PAGE)

are inconsistent with that federal policy, as included in certain bilateral or multilateral recognition agreements entered into between the U.S. and one or more foreign governments, authorities or regulatory entities, (iv) preempts inconsistent state insurance measures (*see* below), (v) requires the Director to report to Congress and specified congressional committees on the financial condition and meaningful trends of the insurance industry and actions taken by the Office relating to preemption of state insurance measures, and (vi) establishes an advisory group to the Office.

Federal Preemption of State Law. The bill provides that state insurance measures would be preempted if, and only to the extent that, the measure (i) treats a non-U.S. insurer more or less favorably than a U.S. insurer domiciled in the state, and (ii) is determined to be inconsistent with federal policy on international insurance matters as established by the Office and included in certain bilateral or multilateral recognition agreements entered into between the U.S. and one or more foreign governments, authorities or regulatory entities. The Director would first make the determination whether inconsistencies exist. Any such determination would then be subject to (i) public notice of an initial and final determination, (ii) consultation with the Office's advisory group, (iii) possible stay of any preemption by the Secretary of the Treasury (subject to prescribed standards), and (iv) notice to Congress which can take action to prevent the preemption. ■

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Open Market Debt Repurchases: Key Issues to Consider

by Matthew E. Kaplan and Y. Rupa Rao

The current economic crisis has severely and negatively affected all aspects of the financial markets. Many issuer's debt securities are currently trading at a discount to face value. This presents an opportunity for issuers to both decrease the outflow of cash for interest payments and de-lever by retiring debt at less than its face amount. An open market debt repurchase program (a "program") is one way to achieve both of these goals, and this article highlights some key considerations in regard to such a program.[1]

Getting Started. Typically, an issuer hires an investment bank to assist in privately negotiating purchases directly from debtholders, as well as purchases at market prices in the over-the-counter market through the bank's normal trading operations.

Disclosure Issues. Prior to initiating a program, an issuer should review its existing publicly available disclosure and consider whether such disclosure is adequate in light of the circumstances or if additional public disclosure, including a press release announcing the commencement of the program, is appropriate.

Avoid a Tender Offer. In setting up a program, an issuer and its investment bank should be careful not to take any actions that could result in a characterization of the program as a "tender offer". If a debt repurchase program is deemed a tender offer, such program would be required to comply with the tender offer rules set forth by the SEC.

Contractual and Regulatory Restrictions. Prior to initiating its program, an issuer should determine whether any of its contracts or agreements (e.g., indentures and credit agreements) prohibit or restrict its ability to repurchase its debt securities. The issuer should consult with regulatory or governmental authorities, where applicable, to determine if there are any restrictions or requirements with which the issuer must comply in order to conduct a program. The issuer also should review its internal securities trading policies for restrictions or limitations on repurchases of its public debt.

Tax Considerations. Repurchases of debt at a discount generally are considered cancellation of indebtedness and result in taxable income equal to the difference between the principal amount of the debt and its repurchase price. Additional issues may arise if repurchased debt is not cancelled and is re-issued at a future date.

The structuring of an open market debt repurchase program requires careful consideration and consultation with external legal, banking and accounting advisers. ■

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[1] *The following discussion considers only a program for unlisted non-convertible debt securities. Different/additional considerations would apply in the case of convertible debt securities or debt securities listed on an exchange.*

Insurers in Crisis: Risks and Opportunities

(continued from cover)

correct the condition or conditions which constituted the grounds for rehabilitation. In a liquidation proceeding, the receiver will generally be vested by operation of law with title to all of the property, contracts and rights of action and all books and records of the insurer.

Guaranty Funds

State guaranty funds can play an important role with respect to transactions with insolvent insurance companies. Guaranty funds are authorized by state insurance law and provide coverage, subject to certain benefit limits, for certain classes of insurance contracts issued to residents of the state by licensed insurers that become insolvent. In an insolvency, the affected state guaranty funds may arrange for reinsurance of covered policies with a solvent reinsurer as part of a receivership proceeding. The guaranty funds raise the necessary amounts by assessments on solvent insurers licensed in the state.

Federal Bankruptcy Proceedings

Though a U.S. insurer cannot be a debtor under the federal Bankruptcy Code, insurance holding companies are subject to the federal bankruptcy laws. A bankruptcy filing by an insurance holding company may result in a receivership proceeding with respect to its insurance company subsidiaries and vice versa. Though the receiver will have the power to control an insurance company subject to receivership proceedings, if there is also an ongoing federal bankruptcy proceeding involving the insurance holding company, the equity of the insurer will be part of the holding company's federal bankruptcy estate.

Transactions with Financially Stressed Insurers

Transactions with financially stressed insurers can take different forms and any given transaction structure will often depend on whether or not an insurer is currently in a receivership proceeding or its holding company is currently in a federal bankruptcy proceeding. For transactions with a financially stressed insurer or its holding company conducted outside of receivership or bankruptcy proceedings, a principal legal consideration is the risk that the transaction could be avoided by a court at a later date. Reasons for which a transaction could be avoided include the determination that the transaction constituted a "fraudulent conveyance" or a "voidable preference". Both concepts are governed by state law.

What constitutes a fraudulent conveyance differs in each state, but generally involves a transfer or an obligation incurred by a debtor if made either (i) with the actual intent to hinder, delay or defraud creditors, or (ii) without receiving reasonably equivalent value and where the debtor was insolvent, rendered insolvent, or had unreasonably small capital to conduct its business or intended to incur debts beyond its ability to pay such debts as they become due. The concept of a fraudulent conveyance under state law is similar to the concept of a fraudulent conveyance under the federal Bankruptcy Code.

Similarly, what constitutes a voidable preference is defined in state insurance law. Under New York insurance law for example, a voidable preference can occur if there is a transfer of, or a lien created on, property of an insurer within a specified time period prior to receivership, such transfer or lien was intended to prefer one creditor over other creditors of the same class, and the creditor accepted such transfer or lien having reasonable cause to believe a preference would occur.

Avoidance risk is usually of less concern in transactions involving insurers that are already in receivership or an insurance holding company that is already in bankruptcy, as such transactions are generally subject to court approval. However, these transactions often involve specialized regulatory considerations and can require balancing multiple regulatory considerations across different jurisdictions.

Transactions with or involving financially stressed insurance companies can take many forms, including bulk reinsurance, acquisitions of an insurer's equity, surplus note issuances, investments in an insurance holding company and acquisitions out of receivership. What follows is a brief overview of each of these structures.

Transactions with or involving financially stressed insurance companies can take many forms, including bulk reinsurance, acquisitions of an insurer's equity, surplus note issuances, investments in an insurance holding company and acquisitions out of receivership.

Bulk Reinsurance

A bulk reinsurance transaction involving a financially stressed insurance company generally takes the form of the reinsurance of a block of business of the financially stressed insurer with a solvent reinsurer. Bulk

Insurers in Crisis continues on next page

Insurers in Crisis: Risks and Opportunities

(continued from previous page)

reinsurance transactions can be structured in different ways and can be coupled with a cut-through clause or endorsement, which gives holders of reinsured policies the right to make claims directly against the reinsurer if the original insurer becomes insolvent. Key considerations include avoidance risk, pricing, whether to use a cut-through endorsement or attempt a novation and the ability of the ceding insurer to restructure following the transaction. Some proposed restructurings have involved the use of a "good insurer/bad insurer" structure to segregate profitable business.

Acquisition of Insurer Equity

The acquisition of an insurer's equity is typically used to implement the sale of business in run-off or to spin off troubled business. Benefits for the acquirer include gaining complete control of operations and the opportunity to profit by managing business in run-off effectively. Risks for an acquirer include avoidance risk and the potential for contingent or undisclosed liabilities beyond those anticipated. With respect to the insurer, benefits include the disposition of troubled operations, which may relieve the perceived overhang posed by the troubled operations on other good business, and considerations include avoidance risk, obtaining regulatory approval and navigating potential policyholder or shareholder actions.

For transactions with a financially stressed insurer or its holding company conducted outside of receivership or bankruptcy proceedings, a principal legal consideration is the risk that the transaction could be avoided by a court at a later date.

Surplus Notes

Surplus notes are a specialized type of obligations of an insurer that are subordinated to all of an insurer's other debt and obligations, though are senior to stock dividend payments and are therefore structurally senior to the debt of the holding company of the insurer. Capital raised by issuing surplus notes is classified as "surplus" for statutory accounting purposes because payments under surplus notes are subject to prior regulatory approval. Surplus notes are generally issued to institutional investors or to affiliates of the insurance company. Key considerations for an investor include payment risk due to potential regulatory disapproval of interest and/or principal payments and the fact that surplus notes will be junior to policyholder claims and all other debt and obligations (but senior to equity) in a liquidation of the insurer. Key considerations for the insurer include pricing, especially in a distress situation, and obtaining regulatory approval for payments.

Investments in an Insurance Holding Company

Investments in an insurance holding company can take the form of an equity stake in the holding company or an investment in debt or convertible debt. Key considerations for an investor include structural subordination to all claims against the insurance subsidiary, and in the case of equity investments, subordination against all other claims against the holding company, the risk of regulatory disapproval of dividends from the insurance company subsidiary, the risk of future market decline and the lack of outright control (which can be mitigated by providing for board representation). Key benefits include the opportunity to benefit if the investment is successful in stabilizing the holding company. Key considerations for the holding company include certainty of closing, standstill and transfer restrictions to protect against any unintended and uncompensated change in control and any shareholder approval requirements.

Acquisitions Out of Receivership

Acquisitions out of receivership can be structured as either an acquisition of a block of business or an acquisition of an insurer's equity. Key considerations for an acquirer include obtaining court approval (and thus limiting avoidance risk), a limited ability to obtain deal protections and a limited ability to obtain meaningful representations, warranties or indemnities. Key considerations for the insurer include whether the acquisition will provide the best result for policyholders and other stakeholders. Where an insurance holding company is also subject to federal bankruptcy proceedings, an acquisition out of receivership can also involve complicated issues involving the interplay between state and federal law and the need for overlapping court approvals. ■

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