Debevoise & Plimpton

Insurance Industry Corporate Governance Newsletter

To Our Clients and Friends,

Last month, our second edition of the Insurance Industry Corporate Governance Newsletter focused on how developments in artificial intelligence ("AI") are affecting insurers, with a particular focus on the concept of "proxy discrimination."

This month, we take a look at the growing role of shareholder activism as a force in the insurance sector.

Framework for Shareholder Activism

Conventional wisdom, going back to the 1980s, held that insurance companies were nearly immune from the pressure of corporate raiders and, by extension, shareholder activists. The occasional exceptions were mostly viewed as proving the rule that well-run insurance companies were too complex, too opaque, too heavily regulated and too hard to break apart for activist campaigns to have much prospect of success.

That conventional wisdom needs to be reconsidered. Examples now abound of companies that find themselves in the crosshairs of activist shareholders. The ongoing activist campaign at Argo Group, the recently announced dispositions at Principal Financial and the pressure being brought to bear on the board of Generali are just a few examples currently in the news that might have seemed unthinkable a few years ago.

We think of activism as having two distinct sources:

- The first is institutional investors—pension funds and index funds, for example —that hold long-term and often sizeable positions in publicly traded insurance companies. These investors may consider themselves unable to exit their investment, either because of the size of the position or because the company forms part of an index and the position cannot be sold. These investors thus have an interest in enhancing the performance of their investments. They may also be more likely to have a social-political agenda, most prominently now in the area of ESG initiatives. In addition to classic corporate governance proposals, these investors have recently tended to focus on environmental policy (greenhouse gas reduction and discouraging investments in fossil fuel projects, for example) and social issues (workforce and board diversity, for example). We can expect this activity to become even more important with the newly released SEC rules on climate change disclosure.
- The second is the more transactional-focused investor—hedge funds and special situation funds—that seeks to create pressure on companies to alter their strategies in specific ways designed to enhance value in the short term. We have seen a multitude of campaigns in recent years in which these types of investors have exploited perceived inefficiencies and used those as the catalyst for strategic transactions. Calls for more efficient capital allocation have driven dispositions of in-force business to focus on less capital intensive, fee earning businesses. Calls for a more focused strategy have driven insurance companies to shed business lines through sales or spin-offs, or exit mature markets in favor of higher growth markets. Hedge fund activists may also seek to pressure boards when a company delivers sub-par results (for example,

due to a bad underwriting result that surprises the market) or challenge an announced M&A deal if it believes the price is insufficient (so-called "bumpitrage"). In conjunction with these campaigns, hedge fund activists often seek board representation.

There is an important aspect of the insurance industry—regulation—that serves as something of a check on the efficacy of activist strategies. The Form A process requires a lengthy approval procedure before an investor may acquire a controlling influence on an insurance company. This question comes into play, for example, when an investor solicits proxies: is there a moment in time when the investor votes the shares represented by the proxies when it can be said to have acquired "control"? Nevertheless, most of the strategies described above can be effectively executed without implicating an acquisition of control for insurance regulatory purposes, and insurance regulators have proven themselves, understandably, reluctant to intervene in shareholder activist campaigns.

What Companies Should Do Now

Publicly traded insurance companies should prepare for activist campaigns in the same way as other companies. They should not assume that either the size or complexity of their businesses, or the overlay of insurance regulation, will serve to spare them.

Boards of directors and senior management should articulate a business strategy that is understood by the market and then execute against that strategy; prepare clear communications that address the interests of key shareholders; review charter and by-law provisions; keep friendly relationships with regulators; focus on ESG issues in a meaningful way; and line up advisors that know the company well and can be called upon if and when needed.

But there is another point to bear in mind as a matter of best governance practices. The insurance industry is changing rapidly. The way business was done even last year may well not be the best strategy for dealing with rapid technological, regulatory, macro-economic, political, demographic and other changes in the markets. In this environment, the best defense is not only to evaluate performance on a retrospective basis, but also to look forward to anticipate how a company will prosper in an evolving environment. Companies will be rewarded for allocating their resources in a manner that anticipates the impact of these changes.

Conclusion

Shareholder activism has become an important force in the insurance sector, and companies should expect that the role played by activists will only increase. Corporate preparedness for an activist campaign includes some basic, ongoing diligence that boards and senior management should regularly undertake. But preparedness also includes an important prospective element: how is a company taking steps to compete in a rapidly changing environment? And what are the forces that will determine corporate success in the years to come?

By focusing on these key questions, insurance companies can not only prepare for activist campaigns challenging their existing business model, but also gain important insights into ways in which the company may take advantage of opportunities presented by a dynamic and evolving industry.

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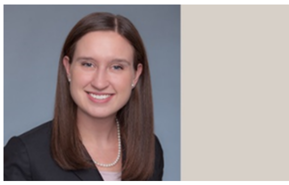

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